

International. A native of New York City, Mr. Murphy was graduated from Villanova University in 1951 with a B.S. degree and received a J.D. degree from Columbia University Law School in 1954.

* * *

WILLIAM MURRAY was elected Vice Chairman of Philip Morris Companies Inc. by the Board of Directors on April 1, 1987. He was elected to the Board of Directors of Philip Morris Companies Inc. on October 1, 1984. Prior to becoming Vice Chairman of the corporation, Mr. Murray served as President and Chief Executive Officer of Philip Morris International since 1983. Mr. Murray has been a Vice President of Philip Morris Incorporated since February 1976 and a Vice President of Philip Morris International since September 1974. As Vice Chairman, he is responsible for the company's worldwide tobacco operations.

Mr. Murray joined Philip Morris in July 1970 as Manager, Finance, for Philip Morris Europe in Lausanne, Switzerland, and shortly thereafter was named Acting Director, Finance. He served subsequently as Vice President, Finance for Philip Morris International, headquartered in New York, and later as Director, Finance, for Philip Morris Incorporated. He was appointed Vice President - Canada and elected President of Benson & Hedges (Canada) Limited in October 1974. In November 1978, Mr. Murray was appointed Executive Vice President of Philip Morris International. He also served as President of Philip Morris Europe/Middle East/Africa from December 1975 to January 1982. He was named President and Chief Executive Officer of Philip Morris International on December 2, 1983. Before joining Philip Morris, Mr. Murray served with the International Labor Organization in Geneva, Switzerland, and prior to that, the United Nations Relief Works Agency, based in Beirut, Lebanon.

Born in Cooma, Australia, Mr. Murray serves on the Boards of Trustees of the Alvin Ailey American Dance Theater, Polytechnic University, the American Museum of Natural History and on the Board of Directors of the International Tennis Hall of Fame. In addition, he is a member of the Institute of Chartered Accountants in Australia. Mr. Murray is a recipient of the Philip Morris "Jewel Ring Award."

2025865273

* * *

FRANK E. RESNIK was appointed Chairman, Philip Morris USA on February 1, 1989. He was previously President and Chief Executive Officer of that company since July 1984, and President and Chief Operating Officer since June 1984. He was elected to the Board of Directors of Philip Morris Companies Inc. on October 1, 1984. Prior to these positions, Mr. Resnik was President of the Tobacco Technology Group of Philip Morris Incorporated.

Mr. Resnik joined Philip Morris USA in 1952 as a Research Chemist and subsequently held numerous supervisory positions at the Research Center in Richmond. He became Director, Commercial Development - Tobacco, in 1967, headquartered in New York. He returned to Richmond in 1971 as Director, Development, and was appointed Director, Research Center Operations, the following year. He returned to the New York office in 1976 to serve as Vice President, Operations Administration, until August 1978. Mr. Resnik served as Vice President, Tobacco Operations, for Philip Morris Incorporated from November 1978 to January 1980. He was named Executive Vice President of the Tobacco Technology Group upon its formation in January 1980 and was appointed President of the group in February 1982. Mr. Resnik has seven patents to his credit and has authored or co-authored more than thirty scientific articles.

Mr. Resnik's leadership roles extend to the areas of public policy and higher education. In June 1985, he became a director of the National Tobacco Education Council. In May 1986, he was elected to the Board of Associates of the University of Richmond, and in August of that year, he was elected to the Board of Directors of the Foundation for State Legislatures. He was elected to the Board of Directors of St. Vincent College in December 1987. In May 1988, he was elected a Sponsor Trustee of the University of Virginia Darden Graduate Business School Sponsors Organization. In September 1988, Mr. Resnik was elected to the Board of Directors of the National Association of Manufacturers.

Mr. Resnik has been equally active in his industry's main trade organization, The Tobacco Institute. Mr. Resnik was elected a member of the board of The Tobacco Institute and Chairman of its Executive Committee in September 1985; he

2025065274

served as Chairman through 1987. He is currently a member of The Institute's Executive Committee. Mr. Resnik is a member of the American Chemical Society (Analytical Section), the American Association for the Advancement of Science, the New York Academy of Science, and The American Institute of Chemists. Among the honors Mr. Resnik has received are an honorary doctoral degree in science conferred by St. Vincent College in May 1985 and the 1988 Horatio Alger Award presented to him in May 1988 by the Horatio Alger Association of Distinguished Americans.

A native of Pleasant Unity, Pennsylvania, Mr. Resnik received a B.S. degree in 1952 from St. Vincent College in Latrobe, Pennsylvania and an M.S. degree in 1955 from the University of Richmond, both in chemistry. He also attended special courses at MIT, RPI, and the Harvard Business School.

* * *

JOHN M. RICHMAN, Chairman and Chief Executive Officer of Kraft General Foods Group, was elected Vice Chairman and a member of the Board of Directors of Philip Morris Companies Inc. in December 1988. Mr. Richman was previously Chairman and Chief Executive Officer and a member of the Board of Directors of Kraft, Inc. since 1979. Mr. Richman joined Kraft's Law Department in 1954 and was appointed General Counsel of the company's former Sealtest Foods Division in 1963. Serving as Assistant General Counsel of the corporation for three years, he was named Vice President and General Counsel in 1970 and Senior Vice President in 1973. Two years later, he was appointed Senior Vice President of Administration. In February 1979, he was elected Deputy Chairman and a member of the Board of Directors of Kraft, Inc. and four months later was named Chairman and Chief Executive Officer of the corporation.

Mr. Richman is a Director of Continental Bank Corporation and Continental Bank N.A., R.R. Donnelley and Sons Company, USX Corporation, and the Evanston Hospital Corporation. He is a Trustee of Northwestern University, and a member of The Business Council and The Business Roundtable. He also serves as a member of both the U.S. Advisory Committee for Trade Negotiations and the Listed Company Advisory Committee to the New York Stock Exchange Board of Directors. In

2025865275

addition, Mr. Richman is a Director of the Chicago Council on Foreign Relations and the Lyric Opera of Chicago and is a Trustee of the Chicago Symphony Orchestra. He is also a member of The Commercial Club of Chicago and the Economic Club of Chicago. Mr. Richman holds a B.A. degree from Yale University and an LL.B. degree from Harvard Law School.

* * *

ANDREW J. SCHRODER III was elected to the General Foods Corporation Board of Directors in November 1985. He has been Senior Vice-President, Administration since October 1981. He had previously been Vice President, Public Affairs since 1977.

Mr. Schroder, who served General Foods as Corporate Secretary from 1973 to 1977, began his career with the company in August 1965 as Senior Attorney. He moved to Corporate Personnel in 1967 where he became Manager of Compensation and Benefits and subsequently was appointed Manager of Personnel Relations. In 1971, he was assigned to the post of Operations Services Manager at the company's largest processing plant, in Dover, Delaware. Mr. Schroder returned to General Foods' headquarters in January 1973 to work on the company's domestic reorganization. He was named Assistant Secretary of the corporation in April 1973 and became Secretary the following year.

A native of Philadelphia, Mr. Schroder holds a B.S. degree and a J.D. degree from Cornell University and an LL.M. degree from Georgetown University. He is a member of the Pennsylvania, Washington, D.C., and New York bars. He served as an officer with the United States Marine Corps in Okinawa and in the Far East.

* * *

GUY L. SMITH IV was elected Vice President, Corporate Affairs for Philip Morris Companies Inc. by the Board of Directors on January 25, 1989. Mr. Smith previously had served as Vice President, Corporate Affairs for Philip Morris USA since August 1984. He also serves as publisher of *Philip Morris Magazine*, Philip Morris's 12-million circulation bimonthly magazine. Mr. Smith joined Philip Morris at its Miller Brewing subsidiary in 1976, where he held several key positions in the public affairs sector. He served as Vice President, Corporate Affairs for The

2025865276

Seven-Up Company, a former Philip Morris company, from 1979-1984. In 1984, he was appointed Vice President, Corporate Affairs, Philip Morris USA. Prior to joining Miller, Mr. Smith was Director of Information and Press Secretary to the Mayor of Knoxville, Tennessee. He also served in Washington, D.C. as Director of Information for the Appalachian Regional Commission. Before that, he was assistant City Editor of *The Knoxville Journal*.

Mr. Smith is a recipient of the "Excellence in News Writing" award of the William Randolph Hearst Foundation. He serves on the Boards of Directors of the Jackie Robinson Foundation, the Laumeier International Sculpture Park in St. Louis, the Public Affairs Council, and The Center for Democracy in Washington, D.C. Mr. Smith is also a member of the Sovereign Military Order of St. John of Jerusalem, of Rhodes, and of Malta.

* * *

RICHARD L. SNYDER was appointed Senior Vice President, Human Resources and Administration, Philip Morris Companies Inc. on November 1, 1987. Mr. Snyder was previously Executive Vice President, Philip Morris International. Mr. Snyder joined Philip Morris Incorporated as Director, Finance in June 1975. He was named Director, Finance and Administration for Philip Morris USA the following month, and was appointed Vice President, Finance and Administration, for that company in November 1975. In October 1979, Mr. Snyder was elected Vice President and Controller of the parent company. He was appointed Senior Vice President, Administration, Philip Morris International in June 1981 and Executive Vice President, Philip Morris International in December 1983, with responsibility for the company's cigarette business in Asia and Australia.

Prior to joining Philip Morris, Mr. Snyder was associated with Wheelabrator-Frye Inc. He joined that firm in 1971 as Corporate Treasurer and was appointed Vice President and Chief Financial Officer for the company's international operations the following year. Mr. Snyder began his career in 1961 with Coopers & Lybrand, where he qualified as a Certified Public Accountant. In 1964, he joined Bell Equipment Corporation as Controller, and was appointed Treasurer in 1966 and Vice President and Chief Financial Officer in 1968.

2025865277

Mr. Snyder is a member of the American Institute of Certified Public Accountants, the Financial Executives Institute, and the National Association of Accountants (NAA). He serves on the Board of Directors of the National Multiple Sclerosis Society and is Treasurer and Chairman of the Society's Finance Committee and is a member of their Audit, Executive, and Long-Range Planning Committees. A native of Carlisle, Pennsylvania, Mr. Snyder was graduated *magna cum laude* from Pennsylvania State University in 1961 with a B.S. degree in Business Administration.

* * *

HANS G. STORR was elected Senior Vice President, Finance, Philip Morris Companies Inc. in April 1987. He was appointed Chief Financial Officer in May 1979. Mr. Storr previously served as Vice President, Finance since August 1978. Mr. Storr has also served as President and Chief Executive Officer of Philip Morris Credit Corporation since February 1982.

After joining Philip Morris in 1957 as an accountant with Milprint, a former subsidiary of Philip Morris, Mr. Storr held several subsequent positions there, including Corporate Cost Supervisor, Financial Analyst, and Projects Manager. Mr. Storr transferred to Philip Morris International in 1966 as Staff Assistant to the Vice President, Finance and was appointed Controller in 1968. In 1973, he assumed the post of Director, Finance and Administration at Philip Morris Europe/Middle East/Africa in Lausanne, Switzerland. In 1974, he was appointed Vice President, Finance and Administration at Philip Morris Europe. He was appointed Vice President, Finance of Philip Morris International in July 1976.

Born in Germany, Mr. Storr was graduated from Hoehere Handelsschule and earned the equivalent of a B.S. degree in Accounting from the University of Wisconsin in 1961. He also holds a certified public accounting certificate from the state of Wisconsin.

* * *

ANDREW WHIST was appointed Senior Vice President, Corporate Affairs Philip Morris International on April 1, 1987. He had served, since December 1980, as Vice President, Corporate Affairs. Mr. Whist was previously Director, Corporate

2025865278

Affairs and Assistant to the Chairman, Philip Morris (Australia) Limited, in Melbourne. He joined the Australian company in 1966 as Marlboro Brand Manager. In 1968, Mr. Whist was appointed Manager, Public Relations and later that year assumed the additional position of Group Brands Manager. In 1970, he was appointed Assistant to the Chairman, and received additional responsibilities when he was appointed Manager, Corporate Affairs in 1972. Mr. Whist was elected to the Board of Directors of Philip Morris Limited in 1976 as Director, Corporate Affairs.

Prior to joining Philip Morris, Mr. Whist held executive positions in Europe, Africa, the Far East, and Canada. Born in Oslo, Norway, Mr. Whist was graduated from Ullern College and pursued additional studies at the Oslo College of Commerce, and Leicester College of Art and Technology in the U.K.

Active in industry and civic affairs, Mr. Whist is Chairman of the Executive Committee of the American European Community Association and Executive Director of the New York Society for International Affairs. Mr. Whist represents Philip Morris on the boards and committees of the International Association of Political Consultants, the Foreign Policy Association, the Overseas Development Council, UN We Believe, the U.S. Chamber of Commerce, the National Foreign Trade Council, and is a member of the International Public Relations Association. Mr. Whist has also been active in several community undertakings, serving as Director of a Wildlife Fund and an Arts Grant. He is also a past Chairman of the Victorian Arts Appreciation Society of Australia.

* * *

DAVID ZELKOWITZ was appointed Staff Vice President, Issues Management for Philip Morris Companies Inc. in January 1988. He was previously Director, Issues Management for Philip Morris Management Corp. since September 1985. Mr. Zelkowitz joined Philip Morris Incorporated in 1961 as a Market Research Analyst. He became a Marketing Analyst for Philip Morris USA in 1964 and Area Research Manager for Philip Morris International in 1967. He transferred to Philip Morris Europe in Lausanne, Switzerland as Market Research Manager in 1969. In February 1972, Mr. Zelkowitz was named Director, Headquarters Marketing for the Europe/Middle East/Africa Region, and in May 1979, was appointed Director, Marketing

2025865279

and Planning for Philip Morris Europe/Middle East/Africa. In 1982, he transferred to the New York office as Director, Business Development for Philip Morris International.

A native of Beuthen, Germany, Mr. Zelkowitz holds a B.S. degree in Mathematics and an M.S. degree in Psychology from City College of New York.

2025865280

2025865281

V. Materials for
Business Overviews

Philip Morris Chronology
Highlights

- 1765 Dr. James Baker, a physician in Dorchester, Massachusetts, sets up the first chocolate factory in the New World.
- 1800 *Philadelphia Brand* cream cheese is introduced by the Phenix Cheese Corporation of Chicago.
- 1847 Philip Morris, Esq., tobacconist and importer of fine seegars, opens a shop on Bond Street in London, England.
- 1855 Frederic Miller opens a brewery in Milwaukee, Wisconsin.
- 1866 Breyer's Ice Cream Company of Philadelphia is established.
- 1882 The Breakstone Bros., Inc. begins selling a full dairy line, including cottage cheese, sour cream, and cream cheese.
- 1883 Oscar Mayer and his brother open a retail meat market in Chicago, Illinois.
- 1885 Joel Cheek introduces a new brand of coffee at the Maxwell House Hotel in Nashville, Tennessee.
- 1887 P.J. Towle, a grocer in St. Paul, Minnesota, blends sugar cane with Vermont and Canadian maple sugar to create a table syrup. He packaged the product in small log-cabin-shaped containers to honor his boyhood hero, Abraham Lincoln.
- 1889 William Wright, a baking powder salesman, devises a better formula for baking powder called *Calumet*.
- 1894 Susan Stavers, owner of a boarding house in Boston, Massachusetts, runs tapioca through a coffee mill which results in a smooth tapioca pudding.
- 1895 C.W. Post and his assistant Clark Bristol begin the Postum Cereal Company, Incorporated, in Battle Creek, Michigan, selling a hot grain-based beverage called *Postum Cereal*.
- 1895 Franklin Baker, a flour miller from Philadelphia, Pennsylvania, goes into the coconut-processing business and develops a conveniently shredded coconut product uniform in quality.
- 1895 Pearl B. Wait, a cough syrup maker in Le Roy, New York, adapts an 1845 patent for a gelatin dessert to which his wife gives the brand name *Jell-O*.
- 1898 William Entenmann emigrates from Germany to Brooklyn, New York, where he joins his brother in the bakery business. Soon after he opens his own bakery in Flatbush and makes home deliveries.

2025865282

- 1902 Philip Morris & Co., Ltd., is incorporated in New York by Gustav Eckmeyer.
- 1903 Canadian-born James Lewis Kraft enters the cheese wholesaling business in Chicago.
- 1913 Charles, Frank, and Edwin Freihofer open a family bakery in Troy, New York after realizing that the working women of the Hudson River textile factories did not have time to bake bread.
- 1914 J.L. Kraft & Bros. starts its first cheese factory in Stockton, Illinois.
- 1915 Emanuel Ronzoni starts his own pasta business in Long Island City, New York.
- 1919 A new firm, owned by American stockholders, acquires the U.S. Philip Morris Company and incorporates in Virginia under the name of Philip Morris & Co. Ltd., Inc.
- 1921 Robert Douglas offers his pectin product to the retail market for home use. A maid suggests the name *Certo* to indicate the pectin's foolproof action.
- 1923 Clarence Birdseye, a Gloucester, Massachusetts scientist, develops plans for a belt freezer to "quick-freeze" food.
- 1925 Postum Cereal Company, Incorporated, acquires The Jell-O Company, Inc., the first of a series of mergers.
- 1926 Clarence Birdseye establishes General Seafoods Corporation to produce quick-frozen fish. Thereafter, he also freezes fruit, vegetables, and meat.
- 1927 Harry Lender begins baking bagels in a garage in New Haven, Connecticut.
- 1929 Formation of the General Foods Corporation (combination of Birdseye's General Foods Company and the Postum Company, Inc.)
- 1929 Philip Morris begins manufacturing its own cigarettes by purchasing a factory in Richmond, Virginia.
- 1933 A bellhop named Johnny, later the product spokesman, calls for Philip Morris for the first time in the Hotel New Yorker lobby.
- 1947 Kraft Television Theater, the first commercial network program, airs for the first time.
- 1953 Perkins Products Company, (responsible for *Kool-Aid* soft-drink mixes), is bought by General Foods Corporation.
- 1954 Philip Morris & Co., Ltd., Inc., acquires Benson & Hedges.
- 1955 An overseas division is set up at Philip Morris.

2025865283

- 1955 Philip Morris Incorporated becomes the company's corporate name.
- 1955 *Marlboro* is introduced nationally in a flip-top box with cork-tipped "selectrate" filter.
- 1967 Three operating companies: Philip Morris Domestic (renamed Philip Morris U.S.A. in 1968), Philip Morris International, and Philip Morris Industrial are established to manage the businesses of Philip Morris Incorporated.
- 1970 Philip Morris Incorporated acquires 100% of Miller Brewing Company.
- 1972 Philip Morris Incorporated acquires 100% of Mission Viejo Company.
- 1976 Kraftco Corporation becomes Kraft, Inc.
- 1978 Philip Morris Incorporated acquires 100% of the Seven-Up Company.
- 1978 Philip Morris Incorporated buys the international cigarette business of the Liggett Group Inc.
- 1980 Kraft, Inc. merges with Dart Industries and forms Dart & Kraft, Inc.
- 1981 Philip Morris Incorporated makes an investment in Rothmans International PLC.
- 1981 General Foods Corporation acquires Oscar Mayer & Co., Inc..
- 1982 Philip Morris Credit Corporation is incorporated.
- 1984 Lenders' Bagel Bakery, Inc. is acquired by Kraft, Inc.
- 1985 The corporate framework of Philip Morris Incorporated is restructured to form Philip Morris Companies Inc., a holding company.
- 1985 Philip Morris Companies Inc. acquires General Foods Corporation.
- 1985 Philip Morris Companies Inc. sells substantially all of Philip Morris Industrial.
- 1986 Dart & Kraft, Inc. sells off most of the company's non-food businesses and changes its name to Kraft, Inc.
- 1986 Philip Morris Companies Inc. sells Seven-Up International and Seven-Up Canada to PepsiCo and the U.S. business of The Seven-Up Company to the Dallas-based firm of Hicks & Haas.
- 1987 Kraft, Inc. acquires the All American Gourmet Company.

2025865284

- 1987 General Foods' three business sectors become three separate operating companies: General Foods, USA; General Foods Worldwide Coffee & International; and Oscar Mayer Foods.
- 1987 General Foods Corporation purchases the New York based Charles Freihofer Baking Company.
- 1987 Miller Brewing Co. acquires Jacob Leinenkugel Brewing Company.
- 1988 Philip Morris acquires Kraft Inc., creating the world's largest consumer products company and the largest U.S. food company.
- 1989 Philip Morris announces the formation of the Kraft General Foods Group.

2025865285



2025865286

REVIEW OF THE YEAR

TOBACCO

Philip Morris U.S.A.'s unit sales, market share, and income from operations once again rose to record levels in 1987.

Our cigarette unit sales rose 0.5% to 215.6 billion units in 1987, despite a 2.1% industry decline to 570.4 billion units. Operating revenues rose 7.4% to \$7.6 billion, while income from operations rose 13.4% to \$2.7 billion.

Our full-price brands continue to increase market share despite the growth of price-value products. Philip Morris now holds 40% of the full-price category, in which we generate 96% of our unit sales.

Continuing its momentum, Marlboro remains America's largest-selling cigarette, with 1987 sales reaching 134.6 billion units, up 0.3% over 1986. Further increases in the brand will be aided by Marlboro Lights, which is growing rapidly. Moreover, Marlboro increased its strength in most demographic categories of smokers.

Virginia Slims widened its lead among cigarettes made especially for women with the successful introduction of Virginia Slims Ultra Lights, an ultra-low tar line extension in a newly designed five-

sided pack. Benson & Hedges successfully introduced Benson & Hedges Lights 100s in a box. The Merit brand continued to benefit from the strong performance of Merit Ultra Lights in the growing ultra-low tar category.

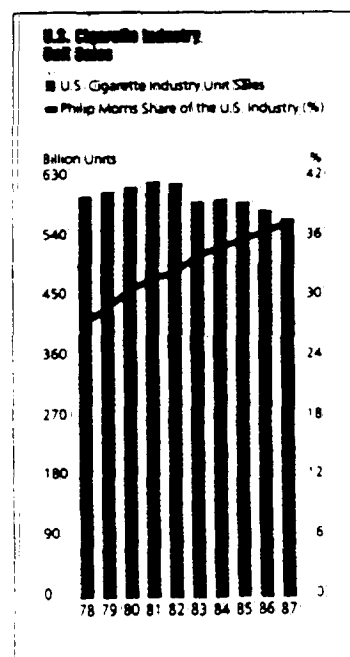
The price-value category, which consists of generic and lower-priced name brands, continued to grow and now accounts for 10% of industry volume. In 1987, Philip Morris U.S.A. introduced full-flavor Cambridge as a quality alternative for price-conscious smokers. The strong performance of the Cambridge brand family led to an increase in the company's share of the price-value category to 15.6%.

Our presence at retail continued to improve as Philip Morris U.S.A. realigned its field sales force to merchandise and promote our products more effectively. In 1987, we increased our share both of retail inventory and of carton and pack display space for all our brands.

American-grown leaf tobacco continues to be the cornerstone of our cigarette blends' superior taste and quality. The Tobacco Program Improvement Act of 1986 has proven effective in enhancing domestic producers' ability to grow quality leaf at competitive prices for the global market.

One part of the program that is proceeding ahead of schedule is the buy-out, by Philip Morris and other major U.S. cigarette manufacturers, of surplus tobacco accumulated from 1976 to 1984 in the growers' cooperatives. The manufacturers have already committed to purchase approximately 60% of these surplus stocks.

Because of increased demand, the U.S. Department of Agriculture has announced an increase in both the flue-cured and burley quotas for 1988. Together, the buy-out, the quota increases, and Philip Morris U.S.A.'s public commitment to purchase more U.S. tobacco as a replacement for imports have provided growers with positive incentives for future production of flue-cured and burley tobacco.



market. We gained market share in Italy and France, and expanded our share of the large German market to 25.4%. In Spain, due primarily to Marlboro's strong performance, we increased volume and improved our share-of-market by 2.7 share points.

Volume was up for our EFTA, Eastern Europe, Middle East, and Africa (EEMA) region. In addition to the very good performance in Turkey, where volume rose 39%, volume also increased in Egypt, Senegal, and Finland. In Switzerland, our market share climbed to a new high of 38%.

Our exports to Eastern Europe were up 30% and our licensees in Poland, Czechoslovakia, East Germany, and Yugoslavia recorded volume gains. In the Middle East Gulf area, where overall industry volume declined,

we continued to increase our share of the market.

Throughout the Latin American region, Marlboro achieved substantial volume gains, increasing 9.4% over 1986. Our market share improved in every major market where we do business. Performance was especially strong in Mexico and the Dominican Republic. In Brazil, our market share rose even though price increases depressed industry volume.

In Canada, we successfully completed the merger of our subsidiary, Benson & Hedges (Canada) Inc., with Rothmans of Pall Mall Limited to form Rothmans, Benson & Hedges Inc. Although industry volume in Canada was down, profitability of the newly combined operations, in which we have a 40% holding, exceeded expectations.

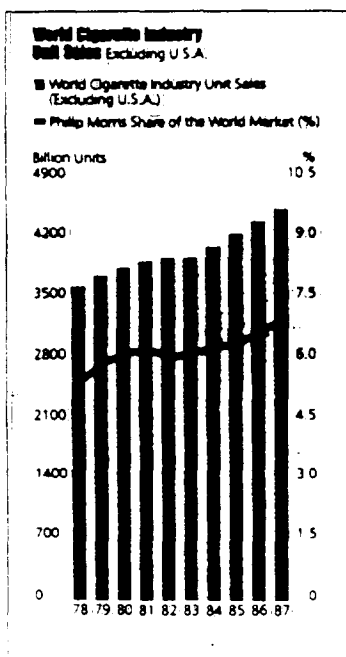
Our Australian cigarette business performed strongly. Volume rose 3% and share improved by 0.8 share points, led by Peter Jackson, which gained 5.6% in volume.

With the suspension of import duties in Japan and improved access to the cigarette market in Taiwan, volume in the Asian region increased dramatically dur-

ing 1987. Volume more than doubled in Japan on strong sales by Lark, Philip Morris Lights, Philip Morris Superlights, and Parliament. Marlboro Lights, produced under license by Japan Tobacco Inc., was introduced in Japan in the fourth quarter. In the growing import segment of this large and important market, our brands hold a 62.8% share.

Following the opening of the Taiwanese market to foreign brands in March, Marlboro, Marlboro Lights, and Parliament achieved an 8.4% share. Volume in the People's Republic of China was up 43.8%. In Hong Kong, Marlboro widened its lead as the best-selling brand, increasing volume and market share by 16.1% and 2.7%, respectively. Marlboro's volume and market share rebounded strongly, recapturing its position as the market leader in Singapore.

The year 1987 was another period of investment for Philip Morris International Inc. Our strong volume performance, together with currency gains, enabled us to further increase our marketing spending in a number of important markets. These investments will have a positive impact on our performance in the years ahead.



FOOD

General Foods Corporation's operating revenues increased to \$9.9 billion, on 2.9% higher unit volume.

Most of General Foods' businesses performed well during the year, with gains in volumes and earnings. Processed meats, baked goods, cereals, and international products were especially strong in 1987. An exception was domestic coffee, where pricing and marketing spending depressed earnings.

Income from operations in 1987 declined 2.7% to \$722 million. The decline reflects a \$117 million pre-tax charge for restructuring,

which was partially offset by a \$46 million pre-tax gain on the sale of the Open Pit barbecue sauce retail business. Excluding these special items, income from operations increased 6.9% to \$793 million.

During the year, General Foods Corporation announced a reorganization program designed to improve management effectiveness and productivity. With the formation of three operating companies — General Foods USA, General Foods Worldwide Coffee & International, and Oscar Mayer Foods — a substantial number of staff positions were eliminated and decision-making was moved closer to the marketplace. Certain manufacturing facilities are also being restructured to improve operating efficiencies, and there were savings in other overhead functions.

General Foods USA

increased its unit volume by 2.3% in 1987.

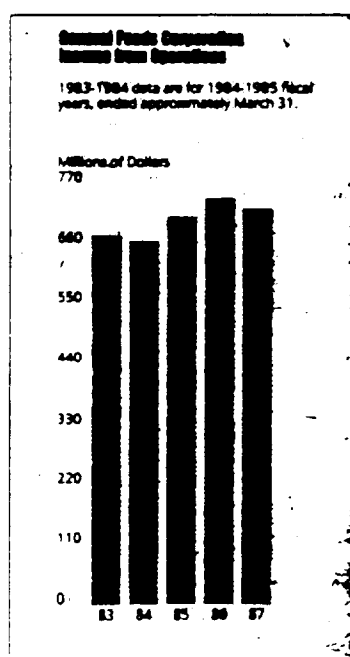
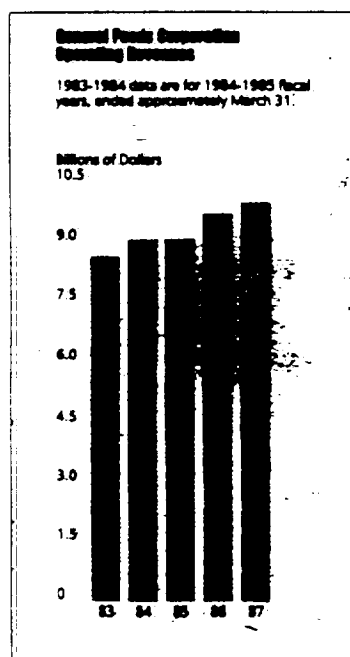
Established products performed well, generally increasing their market shares. In cereals, good volume gains helped Post Grape-Nuts, Natural Raisin Bran, Super Golden Crisp, and Pebbles to improve their positions. During the year, we also introduced an innovative cereal packaging — our resealable Zip-Pak.

Jell-O reversed a volume decline and increased its share of the gelatin market to a new high of 77.4%.

Kool-Aid, Crystal Light, and Country Time increased their share of powdered beverages to 78.4%, with strong earnings growth.

Our bakery business performed well, with Entenmann's successfully expanding to the Pacific Northwest. In November, we completed the acquisition of The Charles Freihofer Baking Company, a major regional baker in the Northeast.

We accelerated new product introductions in all menu segments. Crispy Critters, a new low-sugar children's cereal, was marketed nationally. Entenmann's introduced Fruit & Fibre muffins and a line of "indulgence" pastries.



Kool-Aid Coolers, in its second year of national distribution, achieved a 13% share and is second in the fast-growing aseptically packaged beverage market.

Jell-O refrigerated ready-to-eat puddings were expanded to full distribution on the West Coast after completing a successful test market.

We gained valuable experience in convenience meals, testing Culinova refrigerated entrees, Impromptu shelf-stable meals, and Ronzoni frozen Italian entrees. Birds Eye introduced two new lines: Custom Cuisine and Deluxe Vegetables.

General Foods

Worldwide Coffee &

International unit volume

was up 3.6% over 1986.

Maxwell House and our other brands continued as the overall share leader in the U.S. market. However, operating income gains in our international operations were more than offset by an earnings decline in our domestic coffee business.

Through 1987, the U.S. coffee market failed to recover from 1986's depressed levels. With overall consumption weak, heightened spending by General Foods was needed to compete, which had an adverse impact on earnings.

Early in the year, we launched a new, naturally decaffeinated

Sanka. New packaging and advertising strengthened the position of the Hag brand as Europe's number-one decaffeinated coffee.

We gained share in England with the acquisition of Kenco Coffee Company Limited, a well-established supplier of grocery and food service ground coffee. In Spain, we introduced Saimaza Cafe Superior and widened our lead in the ground coffee market. With broadened distribution, the Gevalia coffee brand increased its share in Scandinavia.

In Canada, our share of coffee in the food-away-from-home market grew with the acquisition of Chase & Sanborn and the Melrose and Dickson food service businesses.

We also increased share in Japan and Korea, and began producing soluble coffee in the People's Republic of China.

All of our non-coffee businesses were strong in 1987. Kibon ice cream in Brazil performed especially well, increasing volume, and earnings despite a difficult economic environment.

In France, our Hollywood gum and Krema confectionery businesses introduced new products and are now distributing Stimerol premium gum in France. We also acquired La Vosgienne, a maker of premium candies.

In January 1988, General Foods' Hostess Food Products, the largest brand of salty snack foods in Canada, announced a plan to form a partnership with Frito-Lay, a unit of PepsiCo, Inc. The partnership is subject to approval of the Canadian government.

Oscar Mayer Foods

continued its leadership

in sliced luncheon meats,

bacon, and hot dogs, as

unit volume increased

3.5%.

The market share of Oscar Mayer brand of sliced luncheon meats rose to 26.1%. Our share of the bacon and hot dog categories rose to 10.9% and 13%, respectively.

The unit volume of Louis Rich turkey products was up 10%, as it continues as the leader in its categories.

Oscar Mayer entered test market with several new products. Zappettes is a line of eight snack foods made especially for microwave ovens. The Lunchables line of convenient light meals includes meat, cheese, and crackers.

We are also expanding distribution of surimi-based products from the Louis Kemp Seafood Company, which was acquired in 1986. It produces a line of lower-cost, natural alternatives to crab meat.

2025865290

BEER

Miller Brewing Company's shipments of 39.3 million barrels were up 1.4%.

Income from operations of \$170 million in 1987 was 10% higher than the 1986 level, while operating revenues rose 1.7% to \$3.1 billion.

In the premium beer segment, Miller Genuine Draft increased its sales strongly over 1986 to 2.6 million barrels.

Miller Lite, the second-best-selling beer in the United States, continues to lead the low-calorie segment by a substantial margin.

Although Miller High Life's volume declined again in 1987, it

remains the third-best-selling beer in the U.S.

In the popular-priced category, Meister Brau and Milwaukee's Best increased their combined volume. Meister Brau Light was introduced during the year in five Eastern states to meet consumer demand for reduced-calorie, popular-priced beers.

During the year, we introduced Matilda Bay Wine Cooler. This is a premium blend of white wine and fruit flavors and is the first non-carbonated wine cooler on the market.

Financial Services and Real Estate Operations

The financing revenues of Philip Morris Credit Corporation (PMCC) declined 1.1% to \$162 million, including intercompany transactions of approximately \$4 million. Net earnings also decreased 6.3% to \$51 million. Year-to-year financial comparisons are distorted because of 1986 adjustments to PMCC's leveraged leasing portfolio resulting from the effects of the Tax Reform Act of 1986 and certain related leveraged lease renegotiations.

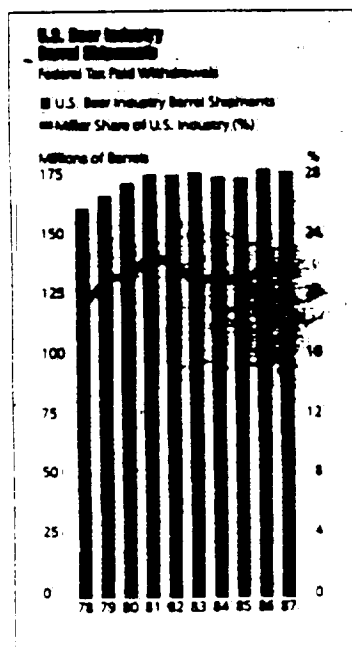
Excluding the impact of this accounting adjustment, PMCC's 1987 financing revenues and net earnings would have increased by 20.9% and 21.1%, respectively, over the prior year. PMCC's growth resulted primarily from the continued expansion of its financial service operations.

In 1987, PMCC invested \$349 million in leveraged leases, bringing the value of the equipment portfolio to almost \$4 billion. We also continued to support Philip Morris' operating companies by providing financing to their customers.

Mission Viejo Realty Group Inc.'s operating revenues exceeded the prior year by 10%. Its 1987 net earnings of \$21 million, including amortization of goodwill, were a record. Although the Colorado real estate market continued to be soft, the California residential housing, land, and business properties markets remained strong.

PMCC was in a good financial position at the end of 1987, with a capital base equaling \$57.9 million. This base provides ample financing capacity to accommodate our growth in 1988 and beyond.

In summary, Philip Morris Companies Inc.'s 1987 results reflected prior years' investments in new product development, in long-term marketing programs, and in modern plant and equipment. We will continue to invest now, for future profitable growth.



SELECTED FINANCIAL DATA—FIFTEEN-YEAR REVIEW (in millions, except per share amounts and employees)

	1987	1986	1985	1984	1983
Summary of Operations:					
Operating revenues	\$27,895	25,409	15,964	13,814	12,976
United States export sales	1,582	1,193	923	925	970
Cost of sales:					
Cost of products sold	11,284	11,039	6,318	5,517	5,343
Federal excise taxes	2,085	2,075	2,049	2,041	1,983
Foreign excise taxes	3,331	2,653	1,766	1,635	1,527
Income from operating companies	4,193	3,707	2,760	2,296	1,944
Interest and other debt expense, net	885	770	308	273	230
Earnings before income taxes	3,348	2,811	2,329	1,607	1,585
Pre-tax profit margin	12.1%	11.1%	14.6%	11.6%	12.2%
Provision for income taxes	\$ 1,506	1,333	1,074	718	681
Net earnings	1,842	1,478	1,255	889	904
Earnings per share	7.75	6.20	5.24	3.62	3.58
Dividends declared per share	3.15	2.475	2.00	1.70	1.45
Weighted average shares	238	239	240	245	252
Capital expenditures	\$ 718	678	347	298	566
Annual depreciation	584	514	367	341	294
Property, plant and equipment (net)	8,582	6,237	5,684	4,014	4,381
Inventories	4,154	3,836	3,827	2,653	2,599
Working capital	1,396	1,432	1,926	1,289	1,117
Total assets	19,145	17,642	17,429	9,339	9,667
Long-term debt	5,222	5,945	7,331	2,059	2,515
Total debt	6,378	6,912	8,009	2,588	3,075
Deferred income taxes	1,288	994	872	784	737
Stockholders' equity	6,823	5,655	4,737	4,093	4,034
Funds from operations	2,789	2,214	1,775	1,547	1,349
Net earnings reinvested	1,083	888	776	472	538
Common dividends declared as % of net earnings	48.8%	39.9%	38.1%	46.8%	40.5%
Book value per common share	\$ 28.83	23.77	19.85	16.86	16.14
Market price of common share high-low	124½-72½	78-43½	47½-36	41½-31	36½-27
Closing price year-end	85½	71½	44½	40½	35½
Price/earnings ratio year-end	11	11	8	11	10
Number of common shares—outstanding at year-end	237	238	239	243	250
Number of employees	113,800	111,000	114,000	68,000	68,000

Income from operating companies is income before corporate expense and interest and other debt expense, net.

Certain amounts appearing in the prior years' consolidated statements of earnings have been reclassified to conform with the current year's presentation.

General Foods Corporation was acquired in November 1985. Accordingly, consolidated operating results shown above include the operating results of General Foods Corporation after October 1985.

In 1984, a write-down of the completed but inactive Miller Brewing Company facility in Trenton, Ohio, reduced earnings before income taxes, net earnings and earnings per share by \$280 million, \$146 million, and \$.59, respectively.

2025865292

1982	1981	1980	1979	1978	1977	1976	1975	1974	1973
11,586	10,722	9,650	8,149	6,633	5,202	4,294	3,642	3,011	2,602
978	834	702	521	424	316	211	158	132	108
5,315	5,024	4,447	3,656	3,072	2,402	1,967	1,657	1,290	1,061
1,180	1,169	1,105	1,037	961	862	778	686	620	559
1,435	1,411	1,389	1,122	703	490	381	392	349	335
1,659	1,403	1,216	1,156	936	761	608	487	402	323
246	232	205	190	137	95	97	95	79	47
1,300	1,068	924	895	746	626	472	361	298	256
11,257	10,057	9,657	11,057	11,257	12,057	11,057	9,957	9,957	9,857
518	408	375	387	337	291	206	149	122	107
782	660	549	508	409	335	266	212	176	149
3,111	2,647	2,220	2,047	1,697	1,407	1,127	0,917	0,797	0,687
1,207	1,007	807	625	513	391	288	231	194	169
251	250	249	249	241	239	238	234	223	219
918	1,019	751	629	566	280	220	245	216	175
250	211	178	133	106	79	65	50	38	30
4,178	3,583	2,806	2,214	1,738	1,202	994	851	660	510
2,834	2,922	2,499	2,235	2,189	1,818	1,658	1,448	1,269	1,009
1,989	1,798	1,662	1,728	1,585	1,416	1,202	891	725	515
9,622	9,115	7,302	6,322	5,608	4,048	3,582	3,134	2,653	2,108
3,746	3,498	2,597	2,447	2,147	1,427	1,248	918	768	500
3,746	3,804	2,800	2,507	2,372	1,564	1,526	1,443	1,239	947
565	411	303	220	150	104	78	71	67	47
3,663	-3,234	2,837	2,471	2,115	1,690	1,430	1,228	975	815
1,160	976	784	703	577	444	348	261	211	178
480	408	350	352	284	254	197	157	132	111
38,657	37,957	36,357	30,657	30,657	27,957	25,757	25,757	24,857	25,057
14,557	12,897	11,377	9,927	8,517	7,057	6,017	5,177	4,267	3,687
3378-22	2774-21	2474-1474	1974-1574	1974-1474	1674-1274	1574-1274	1474-1074	1374-874	1774-1274
30	2474	2174	1874	1774	1574	1574	1374	1274	1474
9	9	9	8	10	11	13	14	15	21
252	251	250	249	249	240	238	237	229	222
72,000	72,000	72,000	65,000	60,000	53,000	51,000	48,000	38,000	37,000

2025865293

2025865294



Kraft... "Good food and good food ideas."

Financial Highlights^(a)

	1987	1986	1985
Net sales	\$9,876	\$7,780	\$7,065
Net income from continuing operations	\$ 435 ^(b)	\$ 394	\$ 362
Per share	3.20 ^(b)	2.79	2.50
Net income from discontinued operations	\$ 54	\$ 19	\$ 104
Per share	.40	.14	.72
Net income	\$ 489	\$ 413	\$ 466
Per share	3.60	2.93	3.22
Dividends paid	\$ 249	\$ 234	\$ 219
Per share	1.84	1.68	1.52 ^(c)
Working capital	\$ 79	\$ 37	\$ 723
Shareholders' equity (c)	\$ 1,898	\$ 1,798	\$ 2,860
Per share	14.47	13.29	19.95
Return on average equity (c) (d)	26.5%	17.7%	17.0%
Return on average total capital (c) (d)	17.7%	14.4%	14.7%
Long-term debt to equity (c)	47.2%	13.2%	15.6%
Total debt to total capital (c)	45.4%	34.4%	16.8%
Capital expenditures	\$ 256	\$ 162	\$ 113
Average number of common and common equivalent shares (thousands)	136,112	140,970	144,898

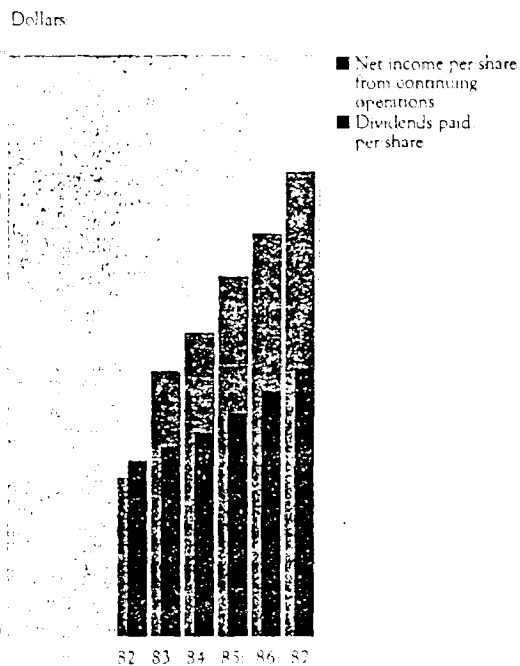
(a) Amounts for years prior to 1987 have been restated to classify results of the discontinued Duracell businesses separately from continuing operations and to reclassify assets and liabilities of the Duracell businesses as net assets of discontinued operations. Data related to shareholders' equity are not affected by this restatement.

(b) Net income from continuing operations for 1987 includes the cumulative effect of the adoption of the new accounting standard for income taxes of \$45.2 million (33 cents per share), substantially offset by an additional tax provision of \$45.0 million (33 cents per share) related to the restructuring of the capital of certain international subsidiaries.

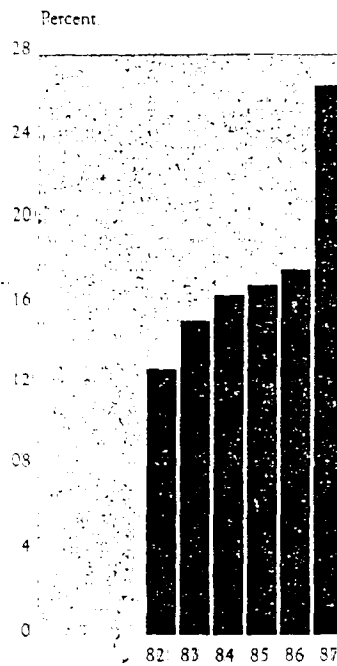
(c) Shareholders' equity reflects the 1986 spinoff of Premark International, Inc. (Premark) and the repurchase of shares in 1987 and 1986.

(d) Returns include results of continuing and discontinued operations.

Net Income Per Share from Continuing Operations and Dividends Paid Per Share



Return on Average Equity

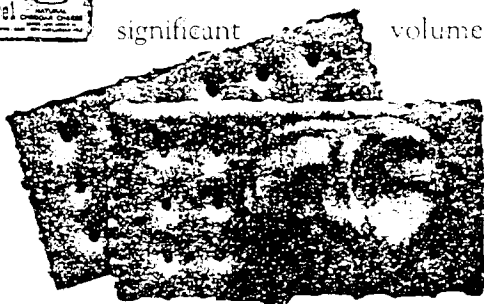
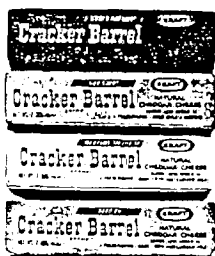


Operations Review

U.S. Consumer Food operating profit advanced 9 percent to \$593 million and sales rose 13 percent to \$4.5 billion. Tonnage exceeded the year-ago level by 11 percent.

Refrigerated Products Group, essentially Kraft's domestic cheese business, had another outstanding year as it achieved substantial gains in profit on higher tonnage and sales. Group results benefited from good expense control, lower cheese costs and modest price increases. In a year marked by intense competitive activity, volume growth was generated by all three of its major product categories – natural, process and cream cheese. Also contributing to overall growth were the *Chumy* and *Purity* specialty cheese lines and the *Polly-O* brand of Italian cheeses. *Purity* was acquired mid-year as part of the Anderson Clayton Foods purchase. To compete more effectively in the marketplace, Refrigerated Products Group strengthened its brand management system by regrouping individual marketing, research and development and manufacturing teams around its core categories: natural cheese, sandwiches, recipe uses, snacks and spreads – which are reflective of consumer uses of Kraft's wide range of cheese products. Every indication is that this approach will enhance competitiveness and lead to the identification of new products that complement the respective category profiles. As in recent years, the group has also benefited from its strategically focused regional sales program. In natural cheese, for example, special promotional programs for its flagship brand, *Kraft 100% Naturals*, generated volume and share gains. Extensions of the group's natural cheese line, *Kraft 100% Natural Shreds* and *Kraft Light Naturals*, a reduced-fat, low-cholesterol cheese that has been expanded into 40 percent of the U.S. market, shared in the success of this localized effort. Sandwich cheese, the category which includes *Kraft Singles*, achieved its highest share in two years due in part to clearer positioning of all of Kraft's branded slice cheese. Line extensions, particularly *Velveeta* slices which is targeted to more price-conscious consumers, and *Kraft Deluxe Slices* added new depth to Kraft's already strong lineup in this business along with significant volume gains. Recipe cheese performance was led by *Cheez Whiz*

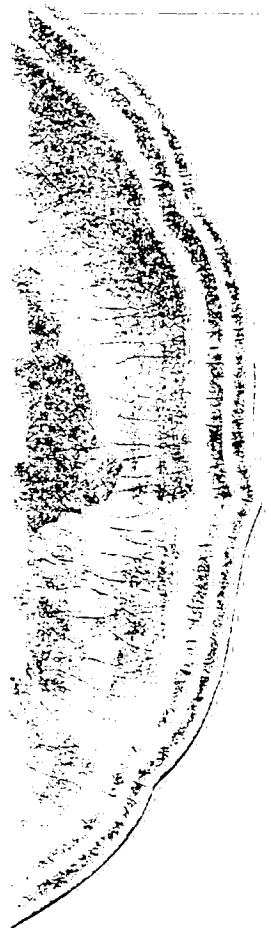
Sandwich cheese, the category which includes *Kraft Singles*, achieved its highest share in two years due in part to clearer positioning of all of Kraft's branded slice cheese. Line extensions, particularly *Velveeta* slices which is targeted to more price-conscious consumers, and *Kraft Deluxe Slices* added new depth to Kraft's already strong lineup in this business along with significant volume gains.



Extensive merchandising and a new Snack container drove volume gains of *Handi-Snack* singles portion cheese food with crackers.



2025865296



pasteurized process cheese spread, which was repositioned in 1986 as a microwavable cheese sauce. In 1987, as in 1986, *Cheez Whiz* achieved record tonnage on the crest of its transition into this growing segment of convenience products. Marketing activity and advertising during the year for *Philadelphia Brand* cream cheese continued to stress that it has "half the calories" of butter or margarine. Also in the year, the national rollout of *Light Philadelphia Brand* process cream cheese product was completed. Refrigerated Products Group anticipates that 1988 will be another year of increased profit, tonnage and sales as its core strategies aimed at increasing cheese usage through better matching of products and consumer needs and sharpened product differentiation remain on track.

Grocery Products Group experienced intense competitive activity in most of its major product categories, particularly margarine, mayonnaise and barbecue sauce. While tonnage was up, sales were unchanged and profit declined. Nonetheless, as a result of aggressive trade spending, the strong market positions held by the group were sustained at or near their historic high levels. **Kraft's** acquisition of Anderson Clayton Foods directly benefited the group as it integrated into its operations *Seven Seas*, a leading brand of pourable dressings particularly in the eastern United States where Kraft in the past has not been strong. Kraft pourable dressings made steady progress, aided by the national expansion of selected mainline flavors in convenient, new squeezable packaging and volume growth in Kraft reduced-calorie pourable dressings. **Miracle Whip** salad dressing posted overall sales and tonnage gains attributable in part to the ever-increasing popularity of *Miracle Whip Light* reduced-calorie salad dressing. Kraft Light reduced-calorie mayonnaise also performed well as it countered aggressive competition which adversely affected Kraft real mayonnaise. **Kraft** remains the undisputed leader of the barbecue sauce category despite modest share erosion in the Kraft-branded line. The group's *Bull's-Eye* brand, which is the taste leader in the super-premium segment and is now in national distribution, grew significantly. **W**ith regard to growth in the packaged dinners category, Kraft recorded tonnage and sales gains over particularly strong 1986 levels. Contributing to volume gains was the performance of *Velveta* shells & cheese dinners, which holds a strong number-two position. Moreover, Kraft expanded its line of easy-to-prepare dinners



The six item line of Kraft frozen dinners has done so well in the market that it will be expanded quickly into new markets.



2025865297

THE BUDGET
GOURMET

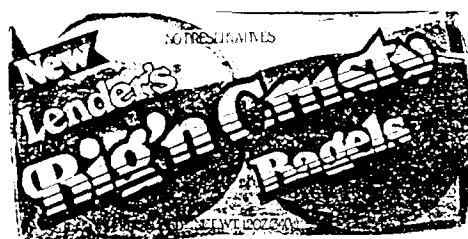


Kraft's
distribution in
the frozen food
market is
growing
steadily
and will
be reaching
the 100 million
pound mark
by 1990.

with *Chicken Applause!* add-meat dinners. In the intensely competitive margarine category, a vigorous defense was mounted for *Parkay* margarine. The result was exceptional tonnage and share growth for this leading brand in 1987, but at the expense of profitability.

Frozen Foods Group is composed of Tombstone Pizza Corporation, Lender's Bagel Bakery and The All American Gourmet Company, manufacturer and marketer of *The Budget Gourmet* line of frozen entrees, dinners and side dishes which was acquired in July. Profit, sales and tonnage levels for the group were strong in 1987. All American

Gourmet's profit performance exceeded its acquisition plan target. Combined, its original line and reduced-calorie entrees have achieved the number-two brand national share of frozen single-dish entrees. Building upon the entree business, All American Gourmet's *Three Dish Dinner* line was expanded nationally in 1987 and a new 20-item line of side dishes was introduced into approximately 20 percent of the U.S. market. Tombstone Pizza Corporation, with sales and tonnage up briskly and well ahead of the total pizza category, had an outstanding year in profit. Following the recent expansion of Tombstone's store-door distribution system to Atlanta, Houston, San Antonio and Austin, the business is now represented in 30 percent of the U.S. market. Despite its regional distribution, Tombstone holds the number-two share position among regional and national frozen pizza brands. Complementing strong 1987 results in its base business, Tombstone firmly established its super-premium pizza brand, *Double Top*, and successfully launched a new microwavable pizza. In a very competitive environment, Lender's posted record profit on strong volume gains. During the year, Lender's joined promotionally with Burger King in developing its new breakfast bagel sandwich, which has become a permanent item on this fast-food chain's menu. Also contributing to increased bagel consumption were business-building opportunities with *Philadelphia Brand* cream cheese. In other areas, Frozen Foods Group is expanding distribution of Kraft frozen pasta entrees, an internally conceived and developed new microwavable product line that was successfully test marketed in 1987. These mainstream frozen entrees not only have strong business potential but fit strategically with All American Gourmet.



2025865298



Dairy Group had a mixed year. Tonnage and sales were up but profit advanced less than anticipated due to higher manufacturing and raw material costs. The group's frozen desserts recovered from 1986 problems associated with the midsummer market withdrawal of the group's novelty ice cream squares. Breyers ice cream tonnage was well ahead of last year, with added impetus coming from the continued success of the brand's expansion into markets west of the Mississippi. Sealtest ice cream and Frusen Glädjé super-premium ice cream tonnage was lower as a result of competitive pressures during the year. Cultured dairy products were strong performers in 1987, with Light n' Lively lowfat yogurt and Breyers yogurt tonnage up significantly. Light n' Lively yogurt posted record high volume levels each quarter, and Breyers yogurt, which generated excellent tonnage for the year, continued to gain favor among consumers with its Full-of-Fruit formulation. Breakstone's and Sealtest sour cream and Breakstone's and Light n' Lively cottage cheese also achieved solid tonnage increases. With the acquisition last year of the Knudsen operation on the West Coast, Dairy Group secured manufacturing, marketing and distribution channels through which it can further its expansion programs. Although Knudsen's full-year results did not meet initial expectations, this business is currently operating profitably. During the year, substantial progress was made toward regaining Knudsen's historically strong market positions in ice cream and yogurt, while record high share levels were achieved by its cottage cheese and sour cream products.

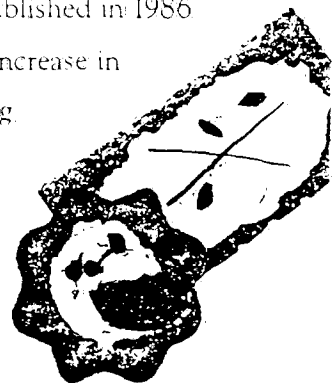
In 1987, Dairy Group upgraded a number of its facilities and closed its Jacksonville, Fla., and Peoria, Ill., plants, resulting in overhead reductions and increased economies of scale. Plans also call for the closing of its Syracuse, N.Y., plant. Dairy Group is expecting significantly improved financial performance in 1988. Key to its profitability will be the successful

implementation of productivity improvement actions covering packaging, manufacturing costs, overhead, distribution and inventory management.

International Food profit rose 26 percent to \$230 million and sales increased 16 percent to \$2.3 billion.

International Group capitalized on the volume momentum established in 1986 by Kraft's core brands. The group benefited from a 3-percent increase in tonnage, cost reductions worldwide from improved manufacturing.

N



efficiencies, productivity gains and lower raw material costs. **P**rofit increased significantly in Europe with especially strong performances in Italy, Germany, the United Kingdom and Spain. Substantial gains were also achieved in Canada and Australia. **H**igher tonnage and lower product costs were largely the factors behind the success of Kraft's operations in Italy, the company's largest profit center in Europe. Contributing strongly to the volume gains were *Jocca* cottage cheese; *Mato Mato* ketchup, which is also being marketed in squeezable bottles; *Kraft* mayonnaise; *Sottilette* process cheese slices; *Philadelphia Brand* cream cheese; and *Invernizzi* cheese products.

In Germany, Kraft had an excellent year with profit up sharply on higher tonnage, lower product costs and a favorable product mix. Tonnage growth was supplemented by the successful launch of new products, which included *Light Philadelphia Brand* cream cheese; *Cravattini*, a line extension of *Miracoli* packaged pasta dinners; and *Belitta* reduced-calorie mayonnaise. **P**rofit in the United Kingdom advanced strongly due to the performance of core brands and lower product costs. Virtually all core brands achieved higher volumes with *Vitalite* sunflower oil-based margarine, *Golden Chum* spread, *Philadelphia Brand* cream cheese and the operation's frozen food products reporting the largest increases. **P**rofit in Canada rose on good gains in its core grocery business along with improved productivity. Effective advertising and the introduction of new products, including *P'tit Quebec* mozzarella and brick cheeses, *Cheez Whiz* Light pasteurized process cheese spread and new flavors for *Philadelphia Brand* cream cheese dips contributed to the improved performance. Good volume gains in items produced for foodservice distribution in Canada were also achieved. **I**n the Pacific area, Kraft Australia turned in healthy profit gains behind effective promotional

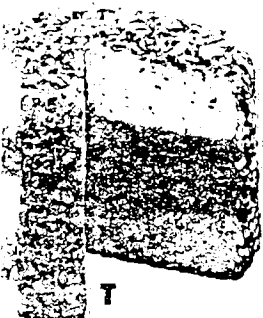
distribution activity, both over the 1986 level. retail product processed *Philadelphia* *Kraft* yeast

programs and extended of which lifted tonnage. Among its major categories, Kraft cheddar cheese loaves, *Brand* cream cheese, pourable dressings, *Vegemite* spread and Kraft peanut butter

Delizia is a new line of gourmet pasta dinners and side dishes available in 12 oz. and 16 oz. packages. It is a new line of gourmet pasta dinners and side dishes available in 12 oz. and 16 oz. packages.



2025865300

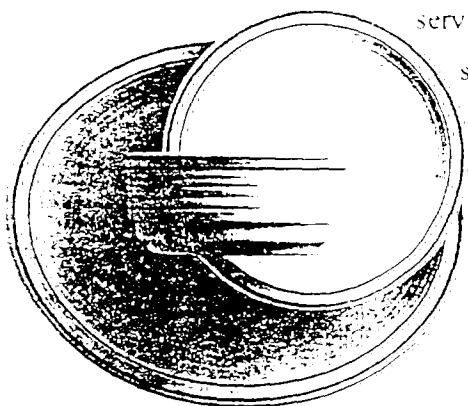


produced good growth during the year. Kraft's business in the Philippines continued to make advances, particularly in process cheese. In Latin America, sales were up but profit was off from last year. In Mexico, tonnage rose in nearly all product categories while profit declined on higher costs. Kraft operations in Venezuela and Panama continued to experience difficult economic conditions which depressed profit and tonnage.






U.S. Commercial Food operating profit rose 9 percent to \$86 million. Sales increased 72 percent to \$3.0 billion and tonnage was up 61 percent, due mostly to acquisitions.

Foodservice Group tonnage and sales nearly doubled, primarily as a result of the addition of distributors acquired in 1986 and 1987. Profit advanced less than anticipated due to costs associated with integrating these businesses into Kraft. Since 1986, Kraft Foodservice has acquired 19 independent foodservice distributors, six in 1987. With this expansion program substantially completed, the group made considerable progress during the year on the integration of these new businesses into its operations. By year end, Kraft Foodservice's distribution system, which now covers 97 percent of the U.S. market, had risen from fourth to second place in this highly fragmented industry. Kraft brings some significant advantages to the business. For one, the company is the only competitor providing its own strong, nationally recognized branded food products which, in 1987, represented nearly one quarter of Kraft Foodservice sales volume. Other competitive advantages include custom product formulation by Kraft's Technology Center, customer and market research expertise, custom packaging capability and substantial portion-control capacity. Already these strengths have earned Kraft Foodservice valuable business with the major restaurant and fast-food chains that require quality, consistency and customized products. Kraft Foodservice is also concentrating on other growth opportunities, including a national program to service supermarket and convenience store delicatessens, bakery departments and salad bars. The company will continue to make investments in foodservice in 1988,

primarily in the area of information systems, which should enable Kraft Foodservice to achieve significant economies and further strengthen its customer service capability.



2025865301



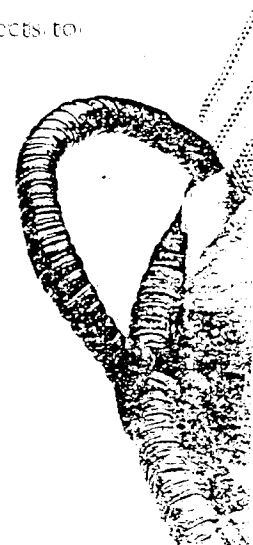
Food Ingredients Group, formerly known as Industrial Foods Group, enhanced its market leadership position in 1987 with the June acquisition of the Anderson Clayton edible-oil business. Including Anderson Clayton's results for the second half of the year, Food Ingredients Group tonnage and sales were up strongly. Operating profit was slightly lower than last year's level, which benefited from a real estate property gain. The Anderson Clayton acquisition has produced a good balance of strong businesses serving customers in all three channels of food distribution - foodservice, food processing and retail through private label and selected branded products - and is building a larger base in specialty ingredients as well. Kraft is now better positioned to capitalize on the good growth potential for food ingredients. In its specialty ingredients business, the group continued to show growth, providing a wide variety of products to food processors. While reduced demand for dehydrated marshmallow bits resulted in an overall volume decline, specialty ingredients enjoyed volume growth during the year in cream cheese, natural cheese, caramels and baking ingredients. In 1988, Food Ingredients Group expects significant volume growth and good gains in operating profit, reflecting the full-year contribution of the Anderson Clayton business along with cost reductions and the scale efficiencies of the combined businesses.

On December 3, 1987, Kraft announced its intent to sell Duracell Inc. Consequently, Duracell is being treated as a discontinued operation for financial reporting purposes. In 1987, Duracell was a significant contributor to Kraft's overall financial performance as its operations continued throughout the year to gain momentum, culminating with excellent results in the fourth quarter when battery sales are at their highest. Duracell net income climbed to \$54 million compared with a loss of \$4 million in 1986, which reflects an after-tax charge of \$26 million related to the refocusing of its activities on its core alkaline battery business. Duracell's sales in 1987 rose 18 percent to \$1.1 billion from \$963 million. Kraft expects to complete the sale of Duracell by mid-1988.



D

2025865302



Lawrence Adelman, CFA, Senior Vice President, 392-3568
 Consumer Group, Research Note
 #155, January 30, 1989

PHILIP MORRIS

Although A Little Confusing At First Glance,
 1988 Results Reached Aggressive Targets; Purchase Recommended

Investment Opinion: BUY — Recommended List

1/26/89 Price (MO/NYSE)	52-Week Range	Earnings per Share			P/E Ratios		Ind. Div.	Current Yield	Normalized 5-Yr. Est. EPS Growth Rate
		1987	1988A	1989E	1988A	1989E			
\$108	\$110-81	\$7.75	\$10.03	\$11.55	10.8	9.4	\$4.50	4.2%	20%
Previous Estimate:		\$10.00		—					
1989 Est. ROE:		33%		Debt as % of Capital (9/30):		36%			

Investment Opinion

As a result of the acquisition of Kraft, Philip Morris has become one of the world's most powerful consumer products companies and offers investors the opportunity for above-average earnings, cash flow and dividend growth. We expect that the dilution from the Kraft acquisition will be eliminated late in 1991 and that Kraft will add modestly to Philip Morris' profits in 1992. Furthermore, the company's earnings mix continues to change, with food and beverage representing an increasingly larger percentage of the total operating profit mix. In 1989 they will equal an estimated 32% of operating profits, versus our original forecast of 20%. Therefore, we believe Philip Morris' price/earnings multiple will shift upward to reflect the higher valuations accorded those businesses. In addition, we expect the market to place a higher valuation on Philip Morris' earnings based on the premium multiple paid for RJR Nabisco, because litigation concerns continue to subside, and because of the company's accelerating market share gains in key worldwide product categories. Thus, purchase of the shares is recommended for capital appreciation.

1988 Results On Target

Although a little confusing at first glance, because of nonrecurring charges and credits, Philip Morris' results in 1988, either in the aggregate or by division, reached or exceeded our expectations. Revenues in 1988 advanced 13% to \$31.7 billion, up from \$28.2 billion in 1987. Sales last year included \$821 million of revenues from the Kraft Corporation, which was included in Philip Morris' results only as of December 7, 1988. Excluding the Kraft contribution, revenues just from ongoing operations rose almost 10% to \$30.9 billion. Earnings per share rose 29% to \$10.03, up from \$7.75 in 1987. (Our estimate was \$10.00 per share.) We would add that in 1988 Philip Morris adopted Financial Accounting Standards No. 96, Accounting for Income Taxes, which resulted in an increase in net income of \$213 million, or \$0.91 per share. We would also note that prior 1988 quarters were restated to give retroactive effect to this change. As a result, earnings per share in the first quarter of 1988

2025865303

were increased by \$1.12 and the second, third, and fourth quarters were reduced by \$0.07, \$0.08, and \$0.06, respectively.

We would also note that the one-time gain from the adoption of the new accounting standard was exactly offset in the fourth quarter by a restructuring charge at General Foods USA and General Foods Worldwide Coffee and International. The charges related to a plant closing, consolidation of manufacturing facilities, early retirement programs and other overhead cost reductions. We estimate that the restructuring will result in improved cost efficiencies of around \$100 million. We would expect these savings to impact reported results commencing in 1990, as the restructuring will be gradually implemented throughout 1989.

Philip Morris' fourth-quarter results were impacted by these events and require some special explanation. First, the company reported that net earnings per share declined by 27% to \$1.48 per share, down from \$2.02 a year earlier. We would note that earnings were negatively impacted by the \$0.91 per share restructuring charge at General Foods and by \$0.06 per share associated with the adoption of FASB #96. Excluding these two items reveals that earnings per share just from operations were \$2.45 per share, which was almost exactly in line with our estimate of \$2.44 per share. Unit shipments in key business sectors expanded in the fourth quarter as follows: Domestic cigarettes, 1.5%; International cigarettes, 2.0%; and Beer 3.5%.

Domestic Cigarettes. Philip Morris' domestic cigarette revenues in 1988 rose 11% to \$8.5 billion, while operating profits benefited from aggressive pricing, and very modest variable cost increases advanced almost 14% to \$3.1 billion. Unit sales rose 1.7% to 219.3 billion sticks, up from 215.6 billion in 1987, and Philip Morris' share of market increased to approximately 39.3% from 37.8%. The Marlboro brand franchise continued an incredibly strong performance, with shipments rising 3.1% to 138.8 billion units, up from 134.6 billion in 1987. Brand volume was boosted by Marlboro Lights and the introduction of Marlboro Menthol.

International Cigarettes. The star performer in Philip Morris' portfolio of tobacco companies continues to be the firm's international cigarette business. Revenues in 1988 advanced 15% to \$8.1 billion, margins expanded to 9.6% from 8.3%, and operating profits climbed 33% to \$774 million. International unit shipments rose 4.4% to 334.7 billion sticks. Sales were boosted significantly by export volume, which advanced 13.2% to 68.8 billion units. On a worldwide basis, including domestic shipments, Philip Morris' total cigarette volume rose 4.4% to 554 billion units.

General Foods. General Foods' worldwide revenues rose 5% to \$10.4 billion, while operating profits were flat at \$771 million before nonrecurring operating charges in both 1987 and 1988. Analyzing General Foods' operations by sector reveals that General Foods U.S.A. experienced a 7.8% increase in unit volume, a 10% rise in operating revenues to \$3.8 billion, and a 14% jump in operating profits, before restructuring costs, to \$438 million. Contributing to this performance were strong results by Bird's Eye, Jell-O, and Kool-Aid.

The worldwide coffee and international business experienced a slight revenue gain to \$4.4 billion. However, operating income excluding restructuring costs fell 34% to \$165 million. Maxwell House continues to have unsatisfactory results. We estimate that the operating losses in domestic coffee equaled or exceeded \$50 million. The major problem was an attempt to recover market share loss experienced earlier in the year, and the marketing expenditures associated with this share reversal severely impacted profits. By contrast, the company experienced a strong performance in the interna-

ADDITIONAL INFORMATION ON COMPANIES MENTIONED IN THIS REPORT IS AVAILABLE ON REQUEST

The information and data in this report were obtained from sources considered reliable. Their accuracy or completeness is not guaranteed, and the giving of the same is not to be deemed an offer or solicitation on our part with respect to the sale or purchase of any securities or commodities. Dean Witter Reynolds and its officers and directors may in the normal course of business have a position in securities mentioned in this report. "S&P 100," "500," "S&P Industrials," and "S&P Composite" are trademarks of Standard & Poor's Corporation.

tional coffee sector, where volume advanced 6% with the strongest gains recorded in Europe and Asia.

Tonnage growth at Oscar Mayer Foods continued to be excellent with sliced luncheon red meat volume rising 7.6%, while tonnage of Louis Rich turkey products expanded 13.7%. Oscar Mayer's total operating revenues increased 5% to \$2.3 billion, and operating income rose over 15% to \$197 million.

The results of Kraft, Inc. were included only since December 7, 1988. On this basis Kraft contributed \$821 million to operating revenues and \$78 million to operating income. Tonnage growth for all of Kraft's divisions in the fourth quarter rose by 4%. On a full year basis, tonnage of U.S. consumer foods and international operations each rose 4%, while volume in the U.S. commercial foods sector expanded almost 19%.

Miller Brewing registered one of its strongest sales gains in many years, with a 3.5% unit volume increase to 40.7 million barrels. While operating revenues rose 5% to \$3.3 billion, margins widened to 5.8% from 5.5% and operating income climbed 12% to \$190 million. The performance of Miller continued to be led by Genuine Draft, the sales of which expanded over 50% for the second consecutive year.

Philip Morris' financial service and real estate units registered a 29% increase in operating revenues to \$629 million, and operating income rose 85% to \$163 million, up from \$88 million in the year-earlier period. The profit advance was aided by an aggressive land sales program in the real estate operations in California. We would note that the acquisition of Kraft did dilute fourth-quarter earnings by \$0.12 per share, and that the full-year tax rate was unusually low at 37.3% reflecting the adoption of FASB No. 96. Importantly, our earnings estimate for 1989 remains unchanged at \$11.55 per share. Other details of Philip Morris' year-end results are outlined in Table 1.

LA

Listed options on this issue are available.

2025865305

TABLE 1

 PHILIP MORRIS COMPANIES INC.

 OPERATING ANALYSIS BY LINES OF BUSINESS

 (Dollar Amounts in Millions)

	1987R	1988	Percent Change

Operating Revenues by Business			

Philip Morris U.S.A.	\$7,640	\$8,501	11%
Philip Morris International	7,004	8,085	15
General Foods Corporation	9,946	10,444	5
Kraft	----	821	
Miller Brewing	3,105	3,262	5
Financial Services, Real Estate & Other	488	629	29

Total Operating Revenues	\$28,183	\$31,742	13
Operating Profits by Business			

Philip Morris U.S.A.	\$2,715	\$3,087	14
Operating Margin	35.5%	36.3%	
Philip Morris International	\$582	\$774	33
Operating Margin	8.3%	9.6%	
General Foods Corporation	\$773	\$771	-0
Operating Margin	7.8%	7.4%	
Kraft	---	\$78	
Operating Margin	---	9.5%	
Miller Brewing	\$170	\$190	12
Operating Margin	5.5%	5.8%	
Financial Services, Real Estate & Other	\$88	\$163	85
Operating Margin	18.0%	25.9%	

Total Operating Income	\$4,328	\$5,063	17
Operating Margin	15.4%	16.0%	
Amortization of Goodwill	\$105	\$125	19
Restructuring of General Foods Corporation	71 (1)	348	390
Unallocated Corporate Expenses	162	193	19
Interest Expense, Net	646	670	4
Pretax Income	\$3,344	\$3,727	11
Taxes	1,502	1,390	-7
Tax Rate	44.9%	37.3%	
Net Income	\$1,842	\$2,337	27
Earnings Per Share	\$7.75	\$10.03	29
Average Shares Outstanding	237.8	233.0	-2

(1) Includes a \$117 million restructuring charge and a \$46 million gain from the sale of Open Pit barbecue sauce.

2025865306

PaineWebber

Philip Morris Companies Inc.

Review of full year results

Buy

- Strong earnings gains from U.S. and international cigarette operations.
- Major restructuring under way in General Foods' coffee business.
- Genuine Draft and Milwaukee's Best boost Miller's barrelage.
- Stock selling at 23% discount to S&P 500 represents unusually good value. Reiterate buy (1) rating.

Philip Morris reported fourth quarter and full year earnings per share of \$1.48 and \$10.03, respectively. Fourth quarter earnings from continuing operations were actually \$2.45 per share, since the \$1.48 figure included the following two factors: 1) a \$0.91 per share charge related to a reserve established for the restructuring of General Foods' domestic coffee business and 2) a \$0.06 per share fourth quarter charge associated with the adoption of SFAS 96 (which for the full year 1988 actually is a credit; see our discussion under point number 5 below). The \$2.45 for the fourth quarter compares to \$2.02 per share earned a year earlier and to our baseline estimate of \$2.54 per share. The variance from forecast derives from the larger than expected operating loss from the domestic coffee business (a \$50 million loss versus our estimate of \$5 million).

For 1989, we are lowering our earnings per share estimate by \$0.10, to \$11.65 from \$11.75. That would be a 16% increase over last year's reported \$10.03. For 1990, we anticipate EPS of \$14.00, a 20% increase over our 1989 estimate.

Highlights of the year are given below:

1. Domestic cigarette units increased 1.7% for the full year. The industry was off an estimated 2.1%. Operating earnings for the division increased 14%, on target with our forecast.

1/25 price \$103 1/2 NYSE — MO 52-week range \$80 1/2 - 103 1/2

FY 12/31	1987	1988	1989E
Q1	\$1.62	\$3.25	\$2.45
Q2	2.00	2.61	3.09
Q3	2.11	2.68	3.18
Q4	2.02	1.48	2.93
Year	7.75	10.03	11.65
P/E			8.9
Div.	\$3.00	\$3.83	\$4.50
Yield			4.3%

Secular Growth Rate

18%

Optionable

2. Overseas, cigarette volume was up 4.4%, with increases in Europe (up 5%) and Asia (up 10%), offset in part by a unit decline in Latin America (off an estimated 4.5%). Operating income for the international cigarette business increased 33%.
3. Miller Brewing Company experienced its best volume growth of the 1980s, with a 3.5% increase. Barrelage growth was led by gains from Genuine Draft (up an estimated 45%) and Milwaukee's Best (up 15%). Operating income for the division increased 12%.
4. General Foods' performance was a mixed bag, with General Foods U.S.A. strong (up 8% in volume and 14% in operating income), and the worldwide/coffee division weak (a 34% decline in earnings and a unit gain of 1%). Oscar Mayer achieved a 10% increase in volume and a 15% increase in operating income.

5. The \$0.91 per share restructuring charge related to the coffee business was taken fully in the fourth quarter. By contrast, the \$0.91 depreciation catch-up credit associated with the adoption of SFAS 96 will affect all four quarters of 1988. The effect is a restatement of last year's quarters as shown in Table 1 (there is some rounding error).

Table 1

	1988 Credit charges from SFAS 96	1988 Restated earnings per share
1st Qtr.	+ \$1.13	\$3.25
2nd Qtr.	+0.07	2.61
3rd Qtr.	+0.08	2.68
4th Qtr.	+0.06	1.48
	\$0.91	\$10.03

Additional information is available upon request.

January 27, 1989

Emanuel Goldman (415) 954-6772
Jacqueline Keyser (415) 954-6773

OVERVIEW OF THE KRAFT GENERAL FOODS GROUP

In February 1989, Philip Morris announced the formation of the Kraft General Foods Group, a functional reorganization of Kraft, Inc. and General Foods Corporation operations. In brief, the Kraft General Foods Group, which is headquartered in Glenview, Illinois, has seven operating units as follows:

General Foods USA, White Plains, New York, includes the following brands: Kool-Aid, Crystal Lite, Tang, and Country Time soft drink mixes; Jell-O gelatin; Entenmann's, Freihofer's, and Oroweat baked goods; Post cereals; Minute Rice; Baker's chocolates; Stove Top stuffings; Ronzoni pastas; and Log Cabin syrups. In addition, the U.S. coffee business (Maxwell House, Sanka, Yuban, Brim, and General Foods International Coffees) is included in this group. The General Foods Food Services Products Division, responsible for sales of coffee and certain other products to food service distributors, is part of General Foods USA.

Kraft USA, Glenview, Illinois, includes the following brands: Kraft natural and processed cheeses; Velveeta; Philadelphia Brand cream cheeses; Cheez Whiz; Miracle Whip; Seven Seas salad dressings; and Parkay and Chiffon margarines. Organizationally, the group is composed of refrigerated and dry grocery products operations as well as the sales, production, technology, and marketing services functions.

Kraft General Foods International, Rye Brook, New York, manages all of Kraft General Foods' businesses outside the United States and Canada, including operations in Europe, Latin America, and the Asia/Pacific region.

Kraft General Foods Canada is a consolidation of all food operations in Canada, a major market for Philip Morris's food products. Among the leading brands in Canada are Kraft and Philadelphia Brand cheese products; Hostess snacks; Jell-O; Birds Eye frozen foods; Frito-Lay snack foods; Cool Whip; and Sanka and Maxwell House coffees.

Oscar Mayer, Madison, Wisconsin, produces Oscar Mayer, Louis Rich, Louis Kemp, and Claussen brands of processed meats and turkey products, processed seafood, and pickles.

2025865309

Kraft General Foods Frozen Products combines several brands, including The Budget Gourmet; Lender's Bagels; dairy products such as Breyers, Sealtest, Light n' Lively, Knudsen, Frusen Glädjé, Cool Whip, and Breakstone's; Birds Eye; Tombstone pizzas; and Jell-O frozen novelties.

U.S. Commercial Products combines Kraft's Foodservice Group and Food Ingredients Group.

2025865310

2025865311

**VI. Materials for
Panel Discussions**

A. Human Resources

2025865312

Whose Business Is It?

Your Job and Your Privacy

John A. Murphy
President, Philip Morris Companies Inc.
Marquette University
May 3, 1988

MU Marquette
University

*An Occasional Paper from the
College of Business Administration*

2025865313

It's tough to be a manager today.

Just look what's on your plate. No matter what your business...no matter where you do it...you feel competitors breathing down your neck, not only from across town, but from Japan, Taiwan, Germany, Korea, Singapore, even Yugoslavia.

Then you've got corporate raiders taking aim to buy you up and bust you up. They say you're a lazy, no-account, entrenched management, wasting the owners' and shareholders' money. If you knew how to manage, they say, then you wouldn't be getting your head handed to you by all those people from Japan, Germany, Korea, Singapore, and even Yugoslavia.

"Some of your employees are doing things other people don't want them to do, a lot of which *you* don't want them to do."

And as if that weren't enough, you probably have discovered recently that social problems and controversies are spilling over into the workplace. By that I mean controversies about how your employees are living their lives.

Some of your employees are doing things other people don't want them to do, a lot of which *you* don't want them to do. And you're told you ought to do something about that, too.

—Some are using illegal drugs...or abusing legal ones. Nobody who cares about this nation's vitality wants them to do that.

—Some of your employees are contracting a deadly and mysterious disease, AIDS, and we all wish they weren't; more than that, a lot of folks wish employees weren't doing the things that put them at *risk* for AIDS.

—Some of your employees are doing something perfectly legal—namely, smoking—but to many people, it's objectionable, and they want *that* to stop.

So there you sit with a plateful of problems in front of you.

2025865314

Do something! you're told. Solve those problems! Prove you're a manager!

Under the circumstances, it's tempting to reach out, grab the problem that looks easiest and quickest to fix, and without a lot of thought, find what looks like the quickest and easiest solution.

"The moral duty to be our brother's keeper doesn't give us the moralizing right to be Big Brother."

Which problem? Well, why not your employees' suspicious habits?

Which solution? Simple. Find out what your employees are doing with their lives. Then threaten to use your power of firing to control them.

That is simple. It's even elegant.

But, my friends, it's wrong.

The moral duty to be our brother's keeper doesn't give us the moralizing right to be Big Brother.

You and I need to resist the temptation—which comes in the name of virtue—to poke our noses into the private lives of our employees. And obviously, since most of us are employees too, that also means resisting ways to let *our* managers poke their noses into *our* lives.

Such snooping doesn't make good business sense, legal sense, or ethical sense. And it short-circuits the actual management process of finding good solutions to real problems.

The pressures to violate privacy start, often, with good intentions (the paving stones of all those roads that lead to one place—and I don't mean Rome or Milwaukee!).

And the good intention is to solve something that has become viewed as a social problem. The leading items that carry the label of "social problem" today are drugs, AIDS, and, yes, drinking alcohol beverages and smoking.

What sort of problem each one of those is, *whose* problem it is, even whether it *is* a problem, are matters of some complexity.

As president of a company where one of our leading products is cigarettes, for instance, not to mention beer, I can do my special pleading on how unjust it is for our products and our consumers to

have the label of "social problem" slapped on *them*. But justly or unjustly, that's how they *are* labeled. And my chief interest today is not to do special pleading for our industry.

My chief interest *is* to speak to you, manager-to-manager, about the ways we managers are being pressed to do something about these social problems.

Oddly, what we're *not* being pressed to do is address the workplace aspect of these problems in a way that makes business and social sense.

Instead, we're being pressed to focus our energies on finding out what our employees do with their lives outside of work.

More than that, we are being pressed to use the threat of job discipline, or loss, to control how our employees choose to live their lives, *whether or not those choices have a specific effect on job performance*. That concept is of key importance.

"The men from Henry Ford's 'Sociological Department' checked into employees' bankbooks to see if they were thrifty."

We are being pressed, in fact, to exercise the kind of control over our employees' lives that hasn't been seen since the days when Henry Ford sent his investigators into the homes and boarding houses of Ford employees, in the decade before World War I, to see that their personal habits and living conditions met company standards.

The men from Ford's "Sociological Department" checked into employees' bankbooks to see if they were thrifty. They checked into their bedrooms and kitchens to see whether they were neat. They checked their diet, their drinking habits, and the time they went to bed, to see if they were leading healthy lives.

And, if a worker failed these company checks, he would not get the famous \$5-a-day wage.

As I noted before, the new intrusive paternalism we are seeing sounds a lot like Henry Ford's approach—well-meaning, but basically not what Americans then or now are willing to accept as the price of a paycheck.

And it's not just that your bankbook, bedroom, and kitchen...and mine...could be checked.

“Random urinalysis, blood, and pulmonary function tests, lie detectors, and electronic eavesdropping are being used to check up on how people live their lives outside of work.”

Things aren't done that crudely—or innocently—today. Today's technology makes it possible for snooping to be more subtle. In fact, that's one element of the temptation. The tools are so readily available.

These days, snooping can be done by random urinalysis tests for drugs...random blood tests for both drugs and the AIDS virus...lie detector tests...electronic eavesdropping...and pulmonary function tests for smoking.

What these tests have in common is that most often they are not being used to diagnose any specific job-performance problem. They are being used broadside, to check up indiscriminately on how people live their lives outside of work.

In part, companies are trying to solve real problems—from impaired employees to soaring insurance costs. There's no doubt about that. But making employment contingent on off-duty behavior dodges the difficult task of dealing justly and fairly with social controversies in the workplace.

Violating our employees' privacy doesn't make business sense in large part because such violations impose an enormous cost on business—one that's out of proportion to their benefits.

Part of the cost is quite literal. For instance, doing random tests well, particularly blood and urine tests, is expensive, as much as 45 to 50 dollars a test. If you're a big operation like we are, such testing could cost you well over a million dollars a year.

There are cheaper tests. But they turn out to be even costlier in the long run since their information is so bad that it becomes unusable if—and more often, when—an employee takes you to court.

What would you find out from these tests? Maybe you indeed would find out who, at some time in the more or less recent past, had used drugs. But you wouldn't know if they'd been impaired. You wouldn't know if they'd been using on

the job. You wouldn't know if they'd been costing your business money.

What you *would* know was what they'd been up to when you weren't around.

Now, that's handy information for a police state. But we run businesses, not an arm of the state—whether police or democratic.

So these tests tell us at the same time both *more* than we need to know to run our businesses (since they reveal what employees do off-hours), and *less* than we need to know to run our businesses (since they don't tell us when employees are impaired on the job).

“We need employees who will bust their fannies for us. They're not going to if they think we're waiting to bust *them*.”

Those are some of the direct costs of efforts to snoop on employees. But I happen to think the indirect costs are even greater and more profound for the long-term lives of our businesses. These are the costs in employee morale, commitment, and loyalty—all fragile commodities anyway these days.

Given the competitive pressures we all face, we need employees who will bust their fannies for us. They're not going to do that if they think you and I are sitting there waiting to bust *them* for something they may or may not be doing off the job.

Violating employee privacy also does not make good legal sense, for the simple reason that courts and legislatures—both state and Federal—have increasingly said companies cannot fire employees for what they do off the job—even if you catch them.

You used to be able to fire non-represented employees—non-union employees, that is—for any reason or no reason, including the fact that you didn't like what they did with their spare time. I don't happen to think that was a particularly good way to treat people. But under the old notion of “employment at will,” you could do it.

These days, that notion is rapidly becoming an historic artifact and ceasing to be a fact of managerial life. More and more state courts allow employees, represented or not, to sue for wrongful discharge.

And employees are doing just that. Alan Westin, the political scientist at Columbia University and expert on privacy, has found that some 25,000 suits alleging termination without cause are now pending in state courts. In the late 70's, he says, there were only about 200. So we've come from 200 to 25,000.

"In violation of privacy suits, the courts are siding with the employees."

More specifically, a substantial number of these suits were brought on the grounds of violation of privacy. The employee says: "I was doing something off the job that you didn't like and you fired me for it."

"And furthermore," says the employee, "I think that's wrong."

While employers sometimes win these suits, the greater tendency is to lose them. The courts are siding with the employees. Between 1985 and mid-1987, according to two Washington lawyers, Ira Shapiro and Robert Durston, there were 97 verdicts against employers in privacy cases. Before 1980, they say, it was practically unheard of for such cases to even get to a jury.

If you respond to social winds, it doesn't take a weatherman to see which way this wind is blowing.

But I don't want you or me to make business policy on the basis of weather reports.

If there were either a business principle or an ethical principle worth defending, then I'd say keep going to court: Damn the legal fees, full speed ahead! (On the other hand, as fiduciaries for our owners and shareholders, I don't think we ought to be encouraging a multiple for corporate legal fees that exceeds our P/E multiple.)

In this case, though, there is neither a business principle nor an ethical principle worth defending. In fact, we're being pressured to practice bad ethics as well as bad business.

That statement may be surprising, I realize, since one view of business ethics is that it's based on business being sensitive and responsive to the desires and preferences of the general public.

That's both true and false—but more false than true, because it leaves out social values.

If popular opinion were our moral touchstone, then when popular opinion said "Don't hire blacks" or "Don't hire women," business would blithely practice discrimination. And 30, even 20, even 10 years ago, that's exactly what a lot of businesses did.

Mine, I'm proud to say, did not. Even though it cost us business, we hired and recruited minorities. In the 1950's, we withstood a boycott of our products in the South organized by the white citizens' councils and the Ku Klux Klan. It hurt our sales ...but we held firm.

We felt then, and feel now, that popular opinion is neither the firmest moral foundation nor the best guide for business policy.

"Invasive solutions to social problems violate the soundest ethical standards of this society."

Rather, we think the proper relation between business policy and general social values is achieved by sticking to fundamental and enduring principles. Those are the best guides for the long run. And among those principles in Western society are "tolerance" ... "fair play" (particularly in the form the lawyers call "due process") ... and "respect for individual choices."

The kind of invasive solutions to social problems that are being urged upon us as business managers violate those principles. Random drug testing, random blood testing, random pulmonary tests—all of them violate the soundest ethical standards of this society.

But wait, we are told, these problems aren't so simple. They're so serious, we're told, we've got to take extreme measures. We're told it's OK to "give up" a little tolerance or a little fairness on these issues. We're assured there'll be no harm done to the general principles of respect, privacy, fairness, and tolerance.

At best that's a naive view. (It's a little like Adam saying to God: "Gee, God, I only took one bite; it's not like I ate the whole apple. What's the big deal?")

As the political scientist Alida Brill has said: "I think it innocent of the history of intolerance to

believe that we can pick and choose among the varieties of intolerance, permit a few, and still come out a society which respects individual difference and personal choice."

Dr. Brill adds: "Official sanctions for controlling *some* personal behaviors set a climate for the control of a series of *other* behaviors."

What Dr. Brill is saying is that intolerance is one tough genie to put back in the bottle. It's contagious.

In short, a simple solution can become one more paving stone on a road, if not to perdition, at least down what the lawyers call the "slippery slope."

"If you get the wrong exercise as prescribed by the company wellness director, why, perhaps the company personnel officer ought to pass you over for a promotion."

Are we now on a similar slope when we are told that business managers ought to control some of the lifestyle choices of their employees outside of work?

Columbia's Professor Westin thinks so. It's a short step, he says, from where we are today to controlling a whole host of off-the-job behaviors.

And he says one stepping stone especially worth noting is so-called corporate "wellness" programs.

In many ways they sum up the whole trend in this country toward a preoccupation with fitness at any price. With their concerns about "proper" diet and "proper" exercise, the logical next step for those programs—given the current climate—is to check, subtly of course, on what you eat at home, how much sleep you get, and how much exercise you get—all of the prescribed sort, of course.

If you eat too much, don't exercise enough, or get the wrong exercise as prescribed by the company wellness director, why then, perhaps the company personnel officer ought to pass you over for a promotion—or fire you.

Among the things I suspect you will not find on the company wellness director's list of approved foods are Ambrosia Chocolate, State Fair Cream Puffs, Usinger's Sausage, and Wisconsin cheese and ice cream—not to mention Oscar Mayer bacon and Miller Genuine Draft and Lite.

And among the approved exercises, I'll bet you won't find running around the countryside on a Harley, or racing your outboard across Lake Michigan.

Is that far-fetched? I don't think so. We've seen that kind of overt control in this country at least once before: across the lake in Henry Ford's Michigan.

If we abandon our ethical standards of privacy, tolerance, fairness, due process, and respect for individual choice now, we are laying the groundwork for attacks later on other lifestyle choices—from eating well-marbled red meat, to driving snowmobiles or high-performance cars, to skiing, to joining a gun club, to watching television (after all, couch potatoes surely are a drag on the national economy and a threat to public health!).

I don't think you and I want to be a party to that.

Does that mean we ought to do nothing about social problems? Does that mean we ought to tolerate anything, anytime—on or off the job—from our employees?

No. It does not.

But it does mean we have to deal with those problems and issues justly and fairly.

"For drug problems, we can develop just and effective policies combining on-the-job performance appraisals with disciplinary systems and assistance programs."

After all, the Constitution may protect all of us from coerced self-incrimination. But it does not protect and condone crime itself.

The Constitution's balanced approach should be our model.

From a business standpoint, I believe there indeed is a great deal we can do to address social problems—insofar as they affect the workplace and show up as specific performance issues.

For instance, for drug problems, we can develop and implement just and effective policies which combine actual on-the-job performance appraisals with disciplinary systems and employee assistance programs. The same thing can be done with alcoholism and other alcohol abuse.

Performance appraisals are hard to do well. I'll grant you. But whoever said we were getting paid

to make the *easy* decisions in this life?

If we want to address the broader social aspect of these problems, we can use company contributions to support drug education and rehabilitation programs such as the very fine one here in Milwaukee at DePaul.

As for AIDS, we can provide medical assistance, understanding, and compassion to our employees who *suffer* from the disease. And we can provide knowledge, and the means to comprehend this terrible disease, for *all* our employees.

We can also make sure we do nothing to feed the hysteria about AIDS, and we can make sure that we do not subtly and not-so-subtly stigmatize those most at risk.

And as with drug problems, we can use our corporate contributions to support programs of research, education, and prevention. Philip Morris, for instance, has just pledged \$100,000 to the National AIDS Fund initiated by the Ford Foundation.

As for smoking, well, I said I didn't want to do any special pleading and I won't. But let me take a stab at this one anyway, knowing that you will probably be doing some considerable discounting of what I have to say.

I believe the same principle applies here as with the other issues. Our focus ought to be on the workplace. And our aim should be to develop policies that are just and fair for all employees—non-smokers and smokers alike.

If you agree with me this far, I'll be happy. Beyond this, I know we may come out at different

“We ought not to fight legislation that sensibly protects employee privacy rights.”

places. For some of you, a total ban on smoking might seem fair.

But I suspect the smokers in your workforce would not agree. Maybe even some of the non-smokers.

That said, I will say I know how complicated it is to put on paper a more comprehensive and just policy for the workplace. I know because we've just gone through that back at Philip Morris headquarters in New York City.

You heard me right. We've put together a written policy which formalizes what we think we've been practicing all along—the principle that smokers and non-smokers can exist peacefully and considerately in the same place.

We've done that even though our office building is exempt from the new smoking ordinance in New York City which mandates such policies for nearly everyone else. We think formalizing our practice is the right thing to do if you are going to be true to your principles.

Ultimately, I think that if all of us are going to be true to our principles of fairness to employees, then we ought not to fight legislation that sensibly protects employee privacy rights. We ought to support such legislation. After all, as employees, too, we'd only be being fair to ourselves. That can't be so hard, can it?

“It took Ford nearly 50 years to catch up again after taking its eye off the ball and putting it on the bedrooms.”

The really hard thing is to get back down to the business of running our businesses well.

If you and I resist the pressure to snoop on our employees, we can get on with our jobs—increasing the real wealth of this nation by producing goods and services that compete in a world marketplace. In that competition to hand heads to people, let's you and I, once again, do the handing, not those guys and gals from Japan, Germany, Korea, Singapore, and even Yugoslavia.

And by the way, do you know what General Motors was doing while Henry was checking up on his employees? GM was learning how to paint cars any color other than black. Car buyers appreciated that. It took Ford nearly 50 years to catch up again after taking its eye off the ball and putting it on the bedrooms.



ORIGINS OF THE RIGHT TO PRIVACY

While legislators, judges, and philosophers seldom agree on what "privacy" is or which privacy interests are entitled to protection from intrusion by government or other people, it is universally accepted in the United States that, as stated in the Declaration of Independence, individuals have certain "inalienable" rights. The right to privacy is often considered by commentators to be one of those rights.¹

The main task confronting employers and employees is determining which privacy rights have been recognized and protected, and how they apply in the workplace. An analysis of workplace privacy rights must begin with a review of the major sources of these rights: common law torts, which limit the acts one person can commit against another; the U.S. Constitution, which limits government activities; and state constitutions and laws, which provide additional rights and protections against specific intrusions into personal privacy.

COMMON LAW RECOGNITION OF PRIVACY RIGHTS

Prior to 1890, no English or American court had ever expressly granted relief based on an individual's right of privacy, although Judge Cooley, an authority on the law of torts, had used the phrase "the right to be let alone" in his treatise.² In 1890, attorneys Samuel D. Warren and Louis D. Brandeis published a landmark article in the *Harvard Law Review* entitled "The Right To Privacy," in which they argued that implicit in a number of common law cases dealing with defamation and property rights was a broader principle — the right to privacy — that should receive separate recognition as a distinct tort action. They stressed that the press was overstepping the bounds of propriety and decency and that "while solitude and privacy has become more essential to the individual; ... modern enterprise and invention have, through invasions upon his privacy, subjected him to mental pain and distress, far greater than could be inflicted by mere bodily injury."³

While for many years legal authorities and the various states could not agree on whether a separate privacy tort should be recognized, some form the tort has now been accepted by the courts or established by legislation in every state.⁴ In a 1960 article explaining how the right to privacy had evolved in the states, professor William Prosser maintained that the right comprises four torts rather than one:

"The law of privacy comprises four distinct kinds of invasion of four different interests of the plaintiff, which are tied together by the common name, but otherwise have almost nothing in common except

Excerpt from Shepard & Dunston, Workplace Privacy (BNA) (1987)

that each represents an interference with the right of the plaintiff, in the phrase coined by Judge Cooley, 'to be let alone'.⁵

Prosser identified these four privacy torts as: (1) appropriation of the name and likeness of another; (2) unreasonable intrusion upon the seclusion of another; (3) unreasonable publicity given to another person's private life; and (4) publicity that unreasonably places a person in a false light before the public. Any person who commits one of these torts may be held liable to the injured person for compensatory and possibly punitive damages.⁶ This four-part analysis of the right to privacy was adopted by the *Restatement (Second) of Torts* in 1977, and it has become accepted by nearly all courts. Several states have adopted this description of the right of privacy by law.⁷ Each of these four privacy torts has been applied in the workplace context.

Appropriation

The oldest recognized privacy right prohibits the appropriation of other individuals' names or likenesses, without their permission, for commercial use.⁸ This tort protects individuals' property interest and their personal interest in not having their names or faces used by others. Sometimes called the "right of publicity," the tort of appropriation has been cited by employees after their company has used photographs of them to advertise its products. The protection against appropriation is firmly established today and is seldom considered novel or controversial.

Intrusion

The rule against intrusion generally states that anyone who intentionally intrudes upon the solitude or seclusion of another person or upon his or her private affairs or concerns is subject to liability if the intrusion would be highly offensive to a reasonable person.⁹ The intrusion can be physical, such as breaking into a person's home, but the principle extends to wiretapping private conversations or looking into the windows of a person's home. The intrusion may also comprise some other form of investigation or examination of individuals' private concerns, such as opening their mail or searching their safes or wallets.¹⁰ The place, item, or thing intruded upon must be private and entitled to privacy. For example, it has been argued that no "right to be let alone" exists on a public street, and therefore it is not an invasion of privacy to follow and watch a person in public.¹¹

The intrusion tort is based on the psychological distress caused by the intrusion itself. The defendant need not have learned anything private or embarrassing about the plaintiff, or wrongfully disclosed any such information. In the workplace, intrusion suits have been brought as a result of an employer's surveillance or investigation of its employees,¹² searches of an employee's personal belongings contrary to the employer's policies and

practices,¹³ and when employers have acted on the basis of an employee's private affairs, such as firing someone for socializing with or dating employees of a competitor.¹⁴

Public Disclosure of Private Facts

This tort prohibits making public matters in the private life of a person if the publicity is highly offensive to a reasonable person and is not of legitimate concern to the public. Liability can be imposed even if the information is true and the plaintiff could not sue for defamation.¹⁵ This tort focuses on publicity given to private facts about individuals. "Publicity" in this context means that the matter is made public by communicating it to a large number of people. Usually it is not an invasion of privacy to communicate a fact about the plaintiff's private life to one person or to a small group of people, but the same statement made in an address to a large audience can be sufficient to establish privacy invasion.¹⁶ For example, it can be an invasion of individuals' rights to publish in a newspaper that they do not pay their debts, but it is not an invasion of privacy to communicate that same information to their employers.¹⁷

For invasion of privacy to occur, the facts that are made public must be private ones. Examples include sexual relations, family quarrels, personal illnesses that carry negative connotations, and other intimate details of an individual's life. In the workplace, employees have brought cases after their supervisors disclosed, without their knowledge or permission, that they had AIDS or that they had received psychiatric treatment. The outcome of these cases sometimes depends on the extent of the publicity and the state where the claim is filed.¹⁸

False Light

The "false light" tort involves publicity that places the plaintiff in a false light in the public eye. It requires a showing that the false light in which the individual is placed would be highly offensive to a reasonable person.¹⁹ The tort is similar in many respects to defamation, but it does not require that the plaintiff be defamed. The classic example of this tort was a suit by Lord Byron to enjoin the circulation of a bad poem that had been attributed to him.²⁰ Another example would be a published photograph that depicts a group of wildcat strikers, but includes a person who was merely passing by when the picture was taken.²¹ In the workplace context, false light claims have been brought in conjunction with defamation claims by employees who felt they had been wrongfully accused of dishonesty or other misconduct.²²

Defenses Against Privacy Invasion Claims

Warren and Brandeis argued in their article that any action that would be privileged under the law of defamation should also be privileged under

the law of privacy.²³ The law of defamation recognizes a qualified privilege when a statement is made in good faith about a subject in which the person communicating it has an interest, and the communication is made to a person who has a corresponding interest. This privilege can apply to employer communications.²⁴ The qualified privilege of employers to protect or further their own legitimate interests has been cited in privacy case rulings that have upheld employers' rights to monitor workers' phone calls and conduct time and motion studies of employees.²⁵ The employer communication privilege has eroded in some jurisdictions in recent years, as juries have increasingly found that employers have waived the privilege because they acted with malice.

PRIVACY RIGHTS UNDER THE U.S. CONSTITUTION

Griswold and Its Progeny

The U.S. Constitution does not contain language expressly providing a right to privacy. In 1928, Justice Brandeis, co-author of the 1890 privacy article, wrote in a dissenting opinion in *Olmstead v. United States*²⁶ that the Fourth Amendment protection against unreasonable searches and seizures extends beyond physical invasions of protected space to include "the right to be let alone." Later U.S. Supreme Court rulings recognized a number of specific constitutional rights relating to personal privacy. But it was not until the 1965 *Griswold* decision,²⁷ a case involving married couples' access to contraceptives, that the Court ruled that an implied privacy right exists within the "penumbras" of guarantees in the Constitution's Bill of Rights. This constitutional right to privacy has been developed through subsequent case law and, although the scope of the right is not well-defined, its existence is recognized.

Justice Douglas' majority opinion in *Griswold* relied on several cases which suggested that the specific guarantees in the Bill of Rights create "zones of privacy." For example, neither the Constitution nor the Bill of Rights mention the freedom to associate with other people. The right to have children educated at schools of their parents' choice — whether public, private, or parochial — is also not mentioned, nor is the right to study any particular subject or any foreign language. Yet the First Amendment has been construed to include these rights.²⁸ *Pierce v. Society of Sisters*²⁹ upheld parents' right to educate their children as they choose, and *Meyer v. Nebraska*³⁰ recognized the right to study the German language in a private school. In each of these cases, the Court ruled that the First Amendment prohibits the state from contracting the spectrum of available knowledge. Similarly, the Court has protected the "freedom to associate and privacy in one's associations," as a peripheral First Amendment right.³¹

Justice Douglas noted that other constitutional guarantees, like those in the First Amendment, had been recognized as protecting the "zones of privacy." The Fourth Amendment affirms the "right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures." The Fifth Amendment's Self-Incrimination Clause enables citizens to create a zone of privacy that government may not force them to surrender to their detriment. The Fourth and Fifth Amendments have been described as providing protection against all governmental invasions "of the sanctity of a man's home and the privacies of life."³² In *Mapp v. Ohio*, the Court said the Fourth Amendment creates a "right to privacy, no less important than any other right carefully and particularly reserved to the people."³³

After reviewing these decisions, Justice Douglas concluded in *Griswold* that "[t]hese cases bear witness that the right of privacy which presses for recognition here is a legitimate one."³⁴ The Court found that the concerns of the marital relationship are within the zone of privacy created by several fundamental constitutional guarantees, and that a state, by forbidding the use of contraceptives, impermissibly intruded on that relationship.

Since *Griswold*, the Court frequently has been presented with cases that seek to define and expand the right of privacy. The most important cases have been in the area of personal relationships and procreation. Justice William Brennan's majority opinion in *Eisenstadt v. Baird*,³⁵ one of several cases that struck down limits on access to contraceptives, observed that if "the right of privacy means anything, it is the right of the individual, married or single, to be free from unwanted governmental intrusions into matters so fundamentally affecting a person as the decision whether to bear or beget a child."³⁶

The Court also has recognized and expanded the right of privacy in other areas. *Whalen v. Roe*³⁷ involved a New York statutory scheme for maintaining computerized records of prescriptions for certain dangerous drugs. Although it upheld the state law, Justice John Paul Stevens' majority opinion recognized that the right to privacy includes more than the specific rights discussed above. Stevens wrote that the right encompasses both the "individual interest in avoiding disclosure of personal matters" and the "interest in independence in making certain kinds of important decisions."³⁸

The constitutional privacy protections that arise from *Griswold* apply to the actions of the federal government and the states, and therefore they cover all public employees. With some limited exceptions, they do not restrict private employers. Absent specific state or federal legislation, only the common law torts such as "invasion of privacy" and "defamation" define the privacy rights of private employees. Nevertheless, the protections afforded public employees are important to private employees because many courts and arbitrators look at constitutional protections for guidance on the type of privacy interests that deserve protection. They

2235985202

often incorporate these concepts, by analogy, in cases involving workplace disputes brought under other theories, such as wrongful discharge.

The Supreme Court has confronted the issue of privacy in the workplace in cases involving search and seizure. The Court has recognized, in the context of criminal litigation, that employees may sometimes have a reasonable expectation of privacy in the workplace. In *Mancusi v. De Forte*,³⁹ the Court concluded that a union official had a personal right under the Fourth Amendment to object to an allegedly unreasonable search and seizure by police of union records from a union office the plaintiff shared with other union officials. The Court found that the union official, who spent considerable time in the office, had custody of records at the time of the seizure and could reasonably have expected that such records would not be touched except with the permission of other union officials. In another criminal case, *Oliver v. United States*,⁴⁰ where the Court found no legitimate expectation of privacy in open fields such as farms or park land, it noted in a footnote that legitimate expectations of privacy may exist in offices and commercial buildings.

These cases foreshadowed an extension of the right to privacy into the workplace, if public employees have a reasonable expectation of protection against searches of desks, lockers, and personal belongings. The extent to which the Fourth Amendment provides a right to privacy in the workplace was presented to the Court this year in *O'Connor v. Ortega*.⁴¹

O'Connor v. Ortega: Workplace Privacy 1987

The Supreme Court addressed in *Ortega* the issue of whether the search of a state employee's desk, without prior notification or his approval, constituted an unreasonable search and seizure in violation of the employee's reasonable expectation of privacy in the workplace. This case is the first civil action of this kind to reach the Court.

Magno Ortega, a psychiatrist, was an employee of a state hospital in California. He had primary responsibility for training physicians in the psychiatric residency program, and had been employed by the hospital for 17 years. Hospital officials became concerned about possible improprieties in Ortega's management of the residency program, particularly his acquisition of a computer that may have been paid for with coerced contributions, plus charges that he had sexually harassed female hospital employees and had taken inappropriate disciplinary action against a resident.

While Ortega was on administrative leave pending investigation of the charges, hospital officials, allegedly to take inventory and secure state property, searched Ortega's office and seized several personal items from his desk and file cabinets — a Valentine's Day card, photographs, and a book of poetry from a former resident — that were used in administrative proceedings that led to his dismissal. No formal inventory of the property was ever made, and the other papers in the office were placed in boxes for

storage. Ortega filed an action against the hospital officials alleging that the search of his office violated the Fourth Amendment.⁴²

The Court addressed two issues: whether Ortega, as a public employee, had a reasonable expectation of privacy in his office, desk, and file cabinets at his place of work, and if so, whether the search was reasonable under the Fourth Amendment.

The Fourth Amendment protects the "right of the people to be secure in their persons, houses, papers and effects, against unreasonable searches and seizures."⁴³ The amendment applies, through the due process clause of the Fourteenth Amendment, to the conduct of state and local government officials, including searches and seizures by government employees or supervisors of the private property of their employees. Previous decisions established that Fourth Amendment rights are implied only if the conduct of the governmental officials infringes on "an expectation of privacy that society is prepared to consider reasonable."⁴⁴ Several factors are used to determine what expectations are considered reasonable, including the intent of those who wrote the Fourth Amendment, the uses to which the individual has put a location, and societal understanding that certain areas deserve protection from the government.⁴⁵

Drawing on *Oliver* and other decisions, the Court held that public employees may have a reasonable expectation of privacy against intrusions in the workplace. As with the expectation of privacy in the home, this expectation of privacy in the workplace is "based upon societal expectations that have deep roots in the history of the Amendment." The Court concluded that public employees *may* have the same reasonable expectations of privacy in their workplaces as private sector employees.

The Court, noting the wide variety of public sector work environments, held that the reasonableness of an expectation of privacy must be decided on a case-by-case basis. For example, the Court observed that an office is seldom a private enclave free from entry by others. It is the nature of government offices that many people — fellow employees, supervisors, visitors, and the general public — may have frequent access to an individual's office. While "constitutional protection against unreasonable searches by the government does not disappear merely because the government has the right to make reasonable intrusions in its capacity as employer,"⁴⁶ some government offices may be so open to fellow employees or to the public that no expectation of privacy is reasonable.

The undisputed evidence disclosed that Ortega did not share his desk or file cabinets with any other employees. Ortega had occupied the office for 17 years and he kept many materials in his office, including personal correspondence, medical files, correspondence from private patients not connected to the hospital, personal financial records, teaching aids and notes, and personal gifts and mementos. The files on physicians in residency training were kept outside Ortega's office. On the basis of this evidence, the Court agreed that Ortega had a reasonable expectation

202585922

of privacy in his desk and file cabinets. Five justices also agreed that Ortega had a reasonable expectation of privacy in his office.

The Court then considered whether the search was reasonable under the Fourth Amendment. What is reasonable depends on the context within which a search is conducted.⁴¹ The standard of reasonableness applicable to different types of searches involves "balancing the nature and quality of the intrusion against the important governmental interest alleged to justify the intrusion."⁴² In the case of searches conducted by a public employer, courts must balance the invasion of employees' legitimate expectations of privacy against the government's need for supervision, control, and efficient operation of the workplace.

The Court found little case law on the appropriate standard of reasonableness for a public employer's work-related search of its employees' offices, desks, or file cabinets. The lower courts that had addressed this issue had generally ruled that any search by an employer satisfies the Fourth Amendment reasonableness requirement if it is "work-related."⁴³ Recognizing that the legitimate privacy interests of public employees in the private objects they bring into the workplace may be substantial, the Court balanced the realities of the workplace and rejected the idea that officials be required to obtain a warrant before they conduct a search. In the Court's view, requiring employers to obtain warrants when they want to enter an employee's office, desk, or file cabinet for a work-related purpose would seriously disrupt the routine conduct of business and would be unduly burdensome.

The Court also considered whether public employers must have probable cause to believe a crime has been committed before searching their employees' offices. Although it recognized that searches usually must be based on probable cause, the Court held in *Ortega* that a probable cause requirement would cause intolerable burdens for public employers confronted with a need to correct employee misconduct or incompetence.⁴⁴ The Court concluded that for legitimate, work-related, non-investigatory intrusions as well as investigations of work-related misconduct, a standard of reasonableness should be applied. This standard, the Court held, would neither unduly burden the efforts of government employers to ensure the efficient and proper operation of the workplace nor authorize arbitrary intrusion into the privacy of public employees.

The standard adopted in *Ortega* means that a search of an employee's office must be "justified at its inception" by the fact that reasonable grounds exist for suspecting that the employee is guilty of work-related misconduct, or because it is necessary for another work-related purpose, such as retrieving a file. The search also must not be excessively intrusive, and the methods used must relate to the objective of the search. The Court remanded *Ortega* so the lower court could apply these standards.

Justice Antonin Scalia concurred in the reversal, but favored a more explicit holding in favor of the employer. He suggested that the reasonable-

ness standard established by a plurality of the justices is "so devoid of content that it produces rather than eliminates uncertainty in this field." Endorsing a supervisor's unrestricted right of access, Justice Scalia suggested that Fourth Amendment protections are limited in light of the government's "special" needs:

[T]he government, like any other employer, needs frequent and convenient access to its desks, files, and offices for work-related purposes. I would hold that government searches to retrieve work-related materials or to investigate violations of workplace rules—searches of the sort that are regarded as reasonable and normal in the private employer context—do not violate the Fourth Amendment.⁴⁵

The balance struck in *Ortega* will have a significant impact on the development of privacy rights in the workplace. The Court's recognition that the government, in its role of an employer, may conduct certain activities that it could not do with other citizens provides a victory for employers, and *Ortega* already is being cited in cases involving drug testing of employees. At the same time, the Court's statement that employees may have a legitimate expectation of privacy in the workplace, although it applies only to searches under the Fourth Amendment, sets the stage for future litigation over employee privacy rights.

State Constitutional Provisions and Laws Affecting Privacy

Most state constitutions have provisions similar to the Fourth Amendment of the U.S. Constitution. These amendments, which are often cited in workplace search or testing cases, have sometimes been interpreted more liberally than the Fourth Amendment.⁴⁶ Several states also have constitutional provisions specifically recognizing and protecting the right of privacy. Article 1, Section 22 of the Alaska Constitution, for example, states: "[t]he right of the people to privacy is recognized and shall not be infringed."⁴⁷

Some of these provisions apply only to the government. Florida's constitution provides that:

Every natural person has the right to be left alone and free from governmental intrusion into his private life except as otherwise provided herein. This section shall not be construed to limit the public's right of access to public records and meetings as provided by law.⁴⁸

Other provisions are more general. The California Constitution recognizes that:

[a]ll people are by nature free and independent and have inalienable rights. Among those are enjoying and defending life and liberty, acquiring, possessing and protecting property, and pursuing and obtaining safety, happiness, and privacy.⁴⁹

This clause has been interpreted to apply to both public and private employers.¹⁶ Although no direct right of action exists for violations of the provisions, an employee might be able to use them as an example of public policy that should be enforced through the law, such as an action for wrongful discharge.

Ten states include some form of privacy guarantee in their constitutions.¹⁷ Where these provisions extend to private employers, employees have an additional tool to challenge invasions of privacy. Where the provisions apply only to public employees, they may be used to demonstrate the "public policy" importance of the right to privacy.

The states are also at the forefront in protecting workplace privacy through specific legislation. Where common law torts are not applicable, private employees often have few remedies in privacy disputes with their employers, except through legislative initiatives. As a result, recognition of employee rights in areas such as polygraph tests and other privacy issues have more often come through legislation than litigation. The development of state privacy laws has varied among the states, but it is likely to increase as workplace privacy issues proliferate.

Footnotes

¹ Tribe, *American Constitutional Law* (New York: The Foundation Press, Inc.) 1978 § 15-3.

² W. Prosser, *Law of Torts*, § 117, at 802 (4th ed. 1971), citing Cooley, *Torts*, at 29 (2d ed. 1888) (herein Prosser).

³ Warren and Brandeis, "The Right To Privacy," 4 *Harv. L. Rev.* 193, 196 (1890).

⁴ States that have recognized the right of privacy by statute include New York, McKinney's Consol. Laws of New York, Civil Rts. § 51 (West 1976), Oklahoma (Okla. Stat. Ann. tit. 21, § 839 (West 1982)), Utah (Utah Code Ann. § 49-3-1 (Allen Smith 1982)), and Virginia (Va. Code Ann. § 18.2-216.1 (Michie 1982)).

⁵ W. Prosser, "Privacy," 48 Calif. L. Rev. 383, 389 (1960). A version of this article appears in Chapter 20 of Prosser's treatise, *Law of Torts*.

⁶ The first tort to be recognized, appropriation of the plaintiff's name or likeness for the defendant's benefit, has rarely been used in disputes between employers and employees. See *Restatement (Second) of Torts* § 652C for a description of this action.

⁷ J. Thomas McCarthy, *The Rights of Publicity and Privacy*, (New York: Clark Boardman Company, Ltd.) 1987 § 1.5. See, e.g., R.I. Gen. Laws § 9-1-28.1 (1980).

⁸ See *Restatement (Second) of Torts* § 652C (1977).

⁹ See *Restatement (Second) of Torts* § 652B (1977).

¹⁰ *Restatement (Second) of Torts* § 652D, comment d (1977); Prosser, § 117 at 807-808.

¹¹ W. Prosser, *Law of Torts* § 117 at 808; Cf. *Prosser and Keeton on Torts*, 5th ed., (West 1984), § 117 at 855-56.

¹² *Pemberton v. Bethlehem Steel Corp.*, 66 Md. App. 133, 502 A.2d 1101 (1986), cert denied, 306 Md. 289, 508 A.2d 488 (1986); cert denied, ____ U.S. ____, 107 S.Ct. 571 (1986).

¹³ *K-Mart Corp. Store No. 7441 v. Trotti*, 677 S.W.2d 632 (Tex. Ct. App. 1984), error refused n.r.e., 686 S.W.2d 593 (Tex. 1985).

¹⁴ *Rulon-Miller v. International Business Machine Corp.*, 162 Cal. App. 241, 208 Cal. Rptr. 524 (1984).

¹⁵ *Restatement (Second) of Torts*, § 652D (1977).

¹⁶ *Restatement (Second) of Torts*, § 652D, comment a (1977).

¹⁷ Prosser, § 117 at 810.

¹⁸ Compare *Cronan v. New England Telephone Co.*, No. 80332, 1 HER Cases 651 (Mass. Sup. Ct. 1986), where an invasion of privacy was found, with *Eddy v. Brown*, 715 P.2d 74 (Okla. 1986), where the court found there was not sufficient publicity.

¹⁹ *Restatement (Second) of Torts* § 652E (1977).

²⁰ Prosser, § 117 at 812.

²¹ See, *Restatement (Second) of Torts* § 652E, comment b (1977).

²² *Ledl v. Quik Pik Food Stores, Inc.*, 133 Mich. App. 583, 349 N.W.2d 529 (1984).

²³ Warren and Brandeis at 216.

²⁴ See Chapter VIII.

²⁵ Prosser, § 117 at 818; *Schmukler v. Ohio-Bell Tel. Co.*, 116 N.E.2d 819 (Ohio C.P. 1953) (monitoring of telephone calls to ensure proper service); *Thomas v. General Electric Co.*, 207 F. Supp. 792 (W.D. Ky. 1962) (time and motion studies); *City of University Heights v. Conloy*, 20 Ohio Misc. 112, 252 N.E.2d 198 (1969) (spying on suspected thief).

²⁶ 277 U.S. 438, 471 (1928) (Brandeis, J., dissenting).

²⁷ 381 U.S. 479 (1965).

²⁸ 381 U.S. at 482.

²⁹ 268 U.S. 510 (1925).

³⁰ 262 U.S. 390 (1923).

³¹ *NAACP v. Alabama*, 357 U.S. 449 (1958).

³² *Boyd v. United States*, 116 U.S. 616 (1886).

³³ 367 U.S. 643, 656 (1961).

³⁴ 381 U.S. at 485.

³⁵ 405 U.S. 438 (1970).

³⁶ *Id.* at 453. This line of decisions includes the abortion case, *Roe v. Wade*, 410 U.S. 113 (1973), which extended the right of privacy to a woman's decision to terminate her pregnancy.

³⁷ 429 U.S. 589 (1977).

³⁸ *Id.* at 600.

³⁹ 392 U.S. 364 (1968).

⁴⁰ 466 U.S. 170, 178 (1984).

⁴¹ ____ U.S. ____, 107 S. Ct. 1492 (1987). The text of this decision is included in the appendix.

⁴² *Id.* at ____.

⁴³ U.S. Const. amend. IV.

¹⁴ *Ortega*, 107 S.Ct. at 1497, citing, *United States v. Jacobsen*, 466 U.S. 109, 113 (1984).

¹⁵ *Ortega*, 107 S.Ct. at 1497.

¹⁶ *Ortega*, 107 S.Ct. at 1505 (Scalia, J., concurring).

¹⁷ *New Jersey v. T.L.O.*, 469 U.S. 325, 337 (1985).

¹⁸ See *United States v. Place*, 462 U.S. 696, 703 (1983); *Camera v. Municipal Court*, 387 U.S. 523, 536-37 (1967).

¹⁹ See *United States v. Nasser*, 476 F.2d 1111, 1123 (7th Cir. 1973) ("work-related" searches and seizures are reasonable under the Fourth Amendment); *United States v. Collins*, 349 F.2d 863, 868 (2d Cir. 1965), cert. denied, 383 U.S. 960, (1966) (upholding search and seizure of a government agent's office and desk pursuant to "the power of the Government as defendant's employer, to supervise and investigate the performance of his duties as a Customs employee"); *United States v. Bunkers*, 521 F.2d 1217 (9th Cir.), cert. denied, 423 U.S. 989 (1975) (work-related search of a locker tested under "reasonable cause" standard).

²⁰ *T.L.O.*, 469 U.S. at 351.

²¹ *Ortega*, 107 S.Ct. at 1505-1506 (Scalia, J., concurring).

²² See *In the Matter of Patchogue-Medford Congress of Teachers v. Board of Education of the Patchogue-Medford Union Free School District*, ____ N.Y.2d ____ (N.Y. Ct. App. June 9, 1987).

²³ Alaska Const. art. I, § 22.

²⁴ Fla. Const. art. I, § 23.

²⁵ Cal. Const. art. I, § 1.

²⁶ See *Porten v. University of San Francisco*, 64 Cal. App. 3d 825, 829 n.2, 134 Cal. Rptr. 839 (1976).

²⁷ See Alaska Const. art. I, § 22; Ariz. Const. art. II, § 8 (1982) Cal. Const. art. I, § 1 (1972); Fla. Const. art. I, § 23; Haw. Const. art. I, § 6; Ill. Const. art. I, § 6; La. Const. art. I, § 5 (1975) Mont. Const. art. II, § 10; S.C. Const. art. I, § 10 (1971); Wash. Const. art. I, § 7.

9255985202



TESTING EMPLOYEES

Excerpt from Shepard & Dunston, Workplace Privacy (BNA) (1987)

WORKPLACE SUBSTANCE ABUSE TESTING

A 1985 survey by the National Institute on Drug Abuse (NIDA) found that among employed people between the ages of 20 and 40, 29 percent said they had used an illicit drug at least once in the previous year and 19 percent said they had done so at least once in the previous month. Between 60 and 70 percent said they used alcohol. While the report showed declines in the use of most illegal drugs except cocaine, the results are significant.

Experts agree that alcohol and drug abuse is costly to employers, resulting in increased absenteeism, lower productivity, increased accidents and injuries, and greater use of medical benefits. A 1983 study by the Research Triangle Institute concluded that alcohol abuse cost \$71.5 billion in lost productivity and employment and the losses from drug abuse cost \$34 billion.¹ Another study by the Employee Assistance Society of North America estimates alcohol-related productivity losses at \$39.1 billion per year, and drug-related losses at \$8.3 billion.²

In addition to the adverse monetary effects that substance abuse in the workplace has on employers, substance abusers expose their employers to other potential liabilities. Employers repeatedly have been held responsible for injuries to third parties when their intoxicated employees have had automobile accidents while on company business.³ Many states place a duty on employers to use reasonable care in the selection of employees, and the employer who does not can be held liable if that employee later injures a member of the public or a fellow employee. One employer was held liable for the sexual assault of a guest at the employer's inn by an employee whose alcoholism and tendency toward violence were known by the employer.⁴ Employers have also been found liable for negligent supervision of employees, as where a supervisor escorted an intoxicated employee to his car and accepted his assurance that he could make it home safely. The employee had an auto accident, killing himself and several others.⁵

Most employers are well aware of the problems caused by substance abuse, and many have responded by instituting drug and alcohol policies. These policies vary widely, and may include a prohibition of drugs and alcohol at work, rehabilitation or employee assistance programs (EAPs) for addicted employees, and penalties (including termination) for impairment at work due to drug or alcohol abuse. The most controversial component of these policies is drug and alcohol testing.

Substance abuse testing is on the increase in both the public and private sector. On March 4, 1986, the President's Commission on Organized Crime issued a report, "America's Habit: Drug Abuse, Drug Trafficking,

and Organized Crime," which included the recommendation that all employers screen applicants and employees for drugs and adopt a policy of zero tolerance for drugs. President Reagan's anti-drug campaign led to his issuance of Executive Order No. 12564 on Sept. 15, 1986, requiring all federal agencies to adopt drug testing programs for employees in "sensitive positions." The order also authorized the agencies to test applicants and to test employees in non-sensitive positions (a) upon reasonable suspicion of drug use; (b) in investigations of accidents or unsafe conditions; and (c) as part of a follow-up to a drug rehabilitation program. Upon sixty day notice, any employee found to be using illegal drugs is to be disciplined unless he voluntarily identifies himself, obtains counseling, and remains drug-free. Any employee testing positive who refuses counseling or rehabilitation or does not remain drug-free is to be discharged.⁶

In response, the Department of Transportation (DOT) intends to begin random screening of 26,500 civilian employees and mandatory testing of all employees during periodic physical exams and upon reasonable suspicion of drug use. DOT also has proposed pre-employment, post-accident, and random drug testing of commercial aviation pilots. Other agencies are preparing to begin programs. The Federal Railroad Administration implemented pre-employment screens, post-accident and probable-cause testing, and treatment for the railroad industry in 1986. Although positive test results are down, 5 percent of 759 employees involved in accidents still tested positive for drugs or alcohol, prompting calls for random drug testing.⁷

Testing in the private sector is also growing rapidly. Experts estimated in 1985 that 20 to 25 percent of Fortune 500 companies had or were considering drug testing for applicants. A recent survey of the Fortune 100 by the American Management Association reported that about 45 were doing pre-employment testing at one or more sites.⁸ NIDA reports that over one-third of all Fortune 500 companies have instituted pre-employment screening.⁹ Other recent surveys show between 20 and 33 percent of employers are screening applicants. Of 492 organizations surveyed by the Employment Management Association, 20.9 percent had programs to test employees. Michigan State University reports that 43 percent of those not currently testing for drugs expect to do so in the future.¹⁰

Some employers are reporting significant results. The U.S. Navy reports that while 47 percent of seamen reportedly used illegal drugs in 1980, that rate has fallen to 4 percent. Southern Pacific Railway reports that since a drug and alcohol testing program was implemented the railway has experienced a 67 percent drop in the number of accidents.¹¹ In spite of these reported successes, drug testing remains highly controversial. While protests come from several fronts and are directed at a number of issues, the major charge is that drug testing is a serious invasion of an employee's privacy. Critics object that the usual procedure — collecting a urine sample — is extremely intrusive and embarrassing, often requiring an

employee to perform private bodily functions in the presence of an observer. The test results can reveal significant data about the employee's health beside drug use. Critics also charge that the tests are inaccurate and even the best chemical tests can only measure the presence of drugs, not impairment. Yet a recent public opinion poll conducted by the *New York Times* shows that nearly three-fourths of all full-time workers feel that drug testing in the workplace would be the most effective way to curb drug abuse.¹²

The controversial nature of drug testing has led to numerous privacy challenges. As these challenges progress through the courts, additional guidance is being provided on what are permissible substance abuse policies. The most significant factor in the reported cases is whether the employer is a public entity, subject to constitutional restrictions, or a private employer, not restrained by the U.S. Constitution, and whether the testing is random or done as a result of "probable suspicion."

Constitutional Limits on Testing Public Employees

The Fourth Amendment's prohibition on unreasonable searches and seizures is "designed to protect the personal privacy and dignity of the individual against unwarranted intrusions" by the government.¹³ The restriction applies not only to the police, but to all government officials. Through the application of the due process clause of the Fourteenth Amendment, this restriction extends to the states as employers.¹⁴ It has long been accepted that the Fourth Amendment not only protects against unreasonable searches and seizures in a person's home, but also searches of the person. In the leading case of *Schmerber v. California*, the U.S. Supreme Court held that while the use of the results of a blood test to prove intoxication did not violate the privilege against self-incrimination, the Fourth Amendment restricted the circumstances in which a person could be "searched" through the use of a blood test.¹⁵

Despite strenuous arguments to the contrary by federal and state officials, nearly every court considering the question has determined that drug testing constitutes a "search and seizure" within the meaning of the Fourth Amendment.¹⁶ In accepting the argument that a person has a legitimate expectation of privacy in the collection of urine samples for drug tests, the New York Court of Appeals, the state's highest court, identified the privacy issues involved:

The act of discharging urine is a private, indeed intimate, one and the product may contain revealing information concerning an individual's personal life and habits for those capable of analyzing it. There is no question that requiring a person to disrobe and expose his body or body cavities, or to empty the contents of his pockets, involves a sufficient intrusion on privacy to constitute a search.¹⁷

82ES985202

Recognition that drug tests are covered by the Fourth Amendment is only the first step of the inquiry. The difficult issue is whether a search (or drug test) is "reasonable." The reasonableness standard of the Constitution normally requires that public officials have probable cause and obtain a warrant before conducting a search. In some circumstances, however, it may be reasonable to conduct a search without a warrant and without probable cause. In *Bell v. Wolfish*, the Supreme Court stated:

The test of reasonableness under the Fourth Amendment is not capable of precise definition or mechanical application. In each case it requires a balancing of the need for the particular search against the invasion of personal rights that search entails. Courts must consider the scope of the particular intrusion, the manner in which it is conducted, the justification for initiating it, and the place in which it is conducted.¹⁸

While drug and alcohol testing programs by public agencies generally have been permitted, a number of courts have held that the agency must first have a "reasonable suspicion" concerning a particular employee in order to test that employee. In *Capua v. City of Plainfield*,¹⁹ all city firefighters and police officers were ordered to submit to a surprise urinalysis. Those who tested positive were discharged or asked to resign. Several affected firefighters sued the city and sought to enjoin the testing and the use of the test results. A U.S. district court recognized that the particular testing program subjected the employees to a high degree of bodily intrusion where the employees have a legitimate expectation of privacy. The court noted that tests conducted under the surveillance of government officials are likely to be very embarrassing and humiliating, and that the test results can reveal of confidential medical information besides illegal drug use, such as epilepsy and diabetes. While recognizing the city's interest in a drug-free workplace, the court held that the "mere possibility" of discovering that some firefighters might be using drugs and might be impaired in the future was not a sufficient justification for the tests because the Fourth Amendment requires individualized suspicion that a particular employee is using drugs.²⁰

The New York Court of Appeals reached the same conclusion in the *Patchogue-Medford Congress of Teachers* case. The court recognized that teachers in New York are required to submit to physical examinations to determine their fitness for duty, and thus have a diminished expectation of privacy. There was no dispute that if school authorities had reason to suspect teachers were unfit for teaching duties, they could be compelled to submit to further examinations, including drug testing. But the court struck down the mandatory testing of all employees as unreasonable where there was no evidence that drug abuse was a problem among teachers generally or in that school district. In mid-July, 1987, two additional U.S. district courts reached similar conclusions. One court found that surprise

mass drug tests of police cadets following a tip that some cadets were using narcotics was unreasonable without individualized suspicion, and granted summary judgment on the cadets' claim.²¹ The second court issued a preliminary injunction against random drug and alcohol testing by a public transit system without reasonable suspicion that an employee is under the influence of drugs or alcohol.²²

Several other courts have rejected the "individualized reasonable suspicion" standard. One case involving jockeys noted that there were compelling state interests in the regulation of the horseracing industry, and because of the regulatory scheme, jockeys had a diminished expectation of privacy.²³ The court upheld a random drug testing program under the "administrative exception" to the "reasonable suspicion" standard, which permits certain agencies to conduct warrantless searches pursuant to their regulatory duties (such as customs searches at the border).

Relying on this same "administrative exception," the U.S. Court of Appeals for the Eighth Circuit ruled in *McDonnell v. Hunter* that the random urine testing of correctional institution employees was reasonable based in part on a diminished expectation of privacy in a prison.²⁴ Other courts that have rejected the individualized reasonable suspicion requirement and preliminarily upheld mandatory and random testing, have focused on the government's interest in protecting the public when some employees are in "sensitive positions," including air traffic specialists²⁵ and nuclear power plant employees.²⁶

There are several challenges to Reagan's Executive Order pending in the courts, and ultimately the Supreme Court will have to decide how Fourth Amendment protections for public employees apply to drug and alcohol testing. One case involves compulsory drug testing of applicants for positions in the U.S. Customs Service where job duties involved the interdiction of drugs, the carrying of a firearm, or access to classified information. The testing program included a five-day advance notice provision, follow-up tests, and a strict chain of custody for samples. The U.S. Court of Appeals for the Fifth Circuit sustained the program in *National Treasury Employees Union v. Von Raab*.²⁷ The court found that the test was not as intrusive as a strip or body cavity search, and was to some extent consensual where employees knew of the requirement when applying for the positions. Relying on the *O'Connor v. Ortega* decision, the court focused on the ability of government employers to conduct searches of their employees that would be impermissible in the absence of the employment relationship so long as the search was reasonably aimed at assuring the integrity and competence of employees. Because one of the primary tasks of the Customs Service is the interception of drugs, the court concluded that drug testing of employees was a reasonable intrusion on their privacy.²⁸

It is likely that subsequent cases also will look to the *Ortega* decision for guidance on how to balance public employees' expectations of privacy with

the "substantial government interests in the efficient and proper operation of the workplace." The U.S. Court of Appeals for the District of Columbia Circuit has stated that the first inquiry must be whether there are reasonable grounds for suspecting that the search will turn up evidence of work-related drug use, and that the testing must be reasonably related to those circumstances and not excessively intrusive.²⁹

Limits on Testing Private Employees

The Fourth Amendment does not apply to private employers, except under very limited circumstances when they act in concert with a law enforcement agency.³⁰ Nevertheless, courts and arbitrators can be strongly influenced by constitutional standards of reasonableness when evaluating conduct by private employers. Some state constitutional provisions parallel to the Fourth Amendment may specifically protect privacy interests and a few reach actions by private employers. Constitutional standards also may be cited by employees attempting to show that their discharges violated public policy.³¹ Generally, however, claims against private employers alleging that drug testing violates federal or state constitutions or public policy will fail because there is no government or state action involved.³²

Not all privacy claims rest on search and seizure grounds. A Minnesota woman employed by Domino's Pizza recently challenged the right of the company to test all employees for drugs as a condition of their continued employment. The woman offered to submit to any exam that was limited to on-the-job drug use, or to any exam if the company had reasonable grounds to suspect her of on-the-job use, but she refused to take a mandatory urinalysis. After being discharged, she sued Domino's alleging intrusion into her private affairs, false light invasion of privacy by implying she used illegal drugs, a violation of public policy, and a violation of the implied agreement in a company handbook that testing would be limited to those using drugs or alcohol on the job.³³ Several similar suits, using a variety of contract and tort theories to challenge mandatory drug and alcohol testing, have been filed by the American Civil Liberties Union.³⁴

While the key issue in the public sector is the reasonableness of the intrusion, the focus in the private sector is whether employees have any protectable privacy interest. Random, unannounced testing is the most likely to result in employee resentment and legal challenges. A surprise, random test may be viewed as arbitrary and offensive, even to those workers who are most opposed to illegal drug use.³⁵

Where the testing is based upon reasonable suspicion or upon legitimate need to protect the health and safety of others, the employer's right to test is usually recognized. One recent example involved an employer's written policy that called for testing if a supervisor had reason to suspect an employee was under the influence of drugs or alcohol on the job; refusal to submit to a test could be considered insubordination. An employee who

reported to work in an intoxicated state refused to submit to a chemical test and was discharged. In response to the employee's claim for unemployment benefits, the court stated:

While each individual possesses a right to personal privacy, when an employee is employed in an inherently dangerous occupation where there exists a substantial risk of harm to himself or others, such right must yield to the employer's overriding concern for the safety of all employees when there is a reasonable suspicion on the employer's part that an employee may be under the influence of some intoxicant.³⁶

The Role of Unions in Testing

The most extensive challenges to substance abuse testing in the private sector have involved unionized companies. This is the result of several factors, including the obligation imposed on employers to bargain over changes in working conditions and the fact that disciplinary action taken against an employee who refuses to take or fails a test can be appealed to a neutral arbitrator who applies the terms of a collective bargaining agreement tailored to workplace problems.

It has consistently been held that significant changes in work rules, particularly those carrying disciplinary measures, affect terms and conditions of employment and are thus mandatory subjects of bargaining. It is becoming generally accepted that drug testing is a mandatory subject of bargaining under the National Labor Relations Act (NLRA). The National Relations Labor Board (NLRB) recently issued an unfair labor practice complaint against Pratt & Whitney for unilaterally implementing a mandatory drug testing program.³⁷ In analogous situations, the board has held that a policy change requiring employees to submit to polygraph examinations as a condition of continued employment is a mandatory subject of bargaining³⁸ and the U.S. Court of Appeals for the Third Circuit found that physical examinations were also a mandatory subject. Absent a waiver of the right to bargain about this subject by the employees' union, an employer is required to give prior notice to the union of any proposed substance abuse testing policy and to bargain with the union about the proposal. A failure to do so would be an unfair labor practice in violation of the NLRA.³⁹

There have been a number of court decisions involving challenges to drug or alcohol testing policies brought by unions alleging that the unilateral adoption of these programs by private employers violates collective bargaining agreements or the duty to bargain. In *Stove, Furnace and Allied Appliance Workers International Union v. Weyerhaeuser Paper Co.*,⁴⁰ the court found that the invasion of privacy caused by the drug test and the "black mark" that would be placed on union members' work records and reputations were injuries that could not be redressed if the

testing were not enjoined pending arbitration and that no irreparable harm would come to the company if the injunction was issued.

A contrary result was reached in the District of Columbia Circuit. One federal judge issued a temporary restraining order against a unilaterally implemented drug testing plan at Potomac Electric Power Co., finding the program "draconian" and "almost unheard of in a free society."⁴² Several days later, a different judge dissolved the restraining order and refused to grant a preliminary injunction based upon a finding that any temporary loss of employment could be remedied through the arbitration process. The company also agreed not to implement random testing pending the outcome of the arbitration.⁴³ These recent developments caution against the unilateral implementation of drug policies in unionized companies. The U.S. Chamber of Commerce, in a recent publication for employers, also advises that all employers discuss the implementation of drug and alcohol tests with unions and seek to develop a cooperative program.

On the other hand, there are some cases arising under the Railway Labor Act where employers have been permitted to implement testing programs unilaterally. In *Railway Labor Executives Ass'n v. Norfolk and Western Railway Company*, one union sought to enjoin Norfolk & Western's implementation of a drug screen urinalysis as part of the railroad's routine medical examinations. N&W moved for summary judgment on the ground that this claim was a "minor dispute," thus permitting the company to proceed with its program. The court found that N&W had a long-standing policy against the use of drugs or intoxicants by any employees. The court noted that the union did not show that the urinalysis was a clear departure from the collective bargaining agreement, was arguably justified under the bargaining agreement to insure that employees are physically fit for their jobs.⁴⁴

Even in situations where notice and bargaining may be required, the parties are not always required to reach agreement. When testing programs are proposed during negotiations for a new agreement, parties are required to bargain in good faith. If the employer and union bargain to an impasse, the employer may be permitted to implement unilaterally a substance abuse policy proposed to the union prior to impasse. But this rule does not permit unilateral implementation of testing while a collective bargaining agreement is in effect.

Further, a union may waive the right to bargain about such a proposal. A waiver may occur through a failure to request bargaining after notice, explicit contract language, or acquiescence in the employer's position in contract negotiations after full discussion.⁴⁵ Non-specific, unwritten waivers and consents are not favored by the NLRB, arbitrators, or the courts, and will not eliminate all privacy claims. Even written waivers may be voided by an arbitrator if administered poorly by an employer. An example is *Union Plaza Hotel*,⁴⁶ where a woman who worked as a waiter's helper at a restaurant was ordered by her supervisor to undergo a drug test after

exhibiting bizarre behavior during her early morning shift. Although the woman signed a consent form, she became reluctant to take the urine test after learning that she would be required to urinate in the presence of a female nurse. The employee asked to be permitted to take the test in a room without a water source, where there was no possibility that she could contaminate the sample. This was denied. She then asked the nurse for a robe. This was also denied. Ultimately, the employee refused to submit to the test and was discharged.

The arbitrator found that the employer properly required the grievant to submit to the urine test while being observed by the clinician. He concluded, however, that the nurse's refusal to provide the employee with a robe made the conditions of the test "unnecessarily onerous," and the employer exceeded its rights by requiring the employee to take the test in an unusually embarrassing manner, which violated the employee's privacy expectations. According to the arbitrator, an agreement by a union to permit drug testing does not represent a waiver of its member's rights to preserve a reasonable amount of privacy and dignity.

State Regulation of Private Employers

Numerous bills have been proposed that would regulate private employers' use of drug testing procedures, few have become law. One of the first laws passed is in Vermont, where Act 61 prohibits drug and alcohol testing without probable cause to believe that the employee is using drugs or alcohol on the job.⁴⁷ The law also prohibits terminations based upon the results of the drug test unless the employee completes a drug assistance program and then tests positive. Similar laws have recently been enacted in Connecticut⁴⁸, Iowa⁴⁹, Minnesota⁵⁰, and Montana.⁵¹ All these laws require confirmation testing, and two (Connecticut and Vermont) specify the GC/MS test. All four of these statutes, like Vermont's law, limit the situations in which employers can conduct drug tests: reasonable suspicion (Connecticut and Minnesota), probable cause (Iowa), or reasonable belief of impairment (Montana), with some exceptions for high-risk occupations in Connecticut or safety-sensitive positions in Minnesota. Several of these laws also include requirements that policies be in writing and that notice be given to employees, and regulate laboratories.

In contrast, Utah passed legislation protecting the right of employers to conduct drug tests for individual impairment, investigation of accidents, maintenance of safety, productivity, quality of products and services, or security reasons. Employers who institute procedural safeguards are permitted to fire an employee or refuse to hire an applicant who fails or refuses to take a test.⁵² Similar legislation passed the New Jersey assembly.

One piece of local legislation receiving national attention is a 1985 San Francisco ordinance that prohibits most public and all private employers from conducting any random or company-wide testing of employees for

1885985202

substance abuse. Employees may be tested only if the employer has reasonable grounds to believe that an employee's faculties are so impaired as to pose a clear and present danger to himself and others and if the employer offers the employee the opportunity to challenge the test results.

The debate over when and how drug and alcohol testing can be used is expected to continue in most state legislatures for the foreseeable future. The approaches vary significantly, but even those bills seeking to protect employers from liability mandate that employers use minimally intrusive techniques, institute procedures for proper labeling and handling, and use confirmation tests. At the federal level, attention has been focused on federal workers and public safety workers — primarily in the railroad and airline industries. No comprehensive drug testing bill for private industry has been considered by the full House or Senate.

Common Law Privacy Claims

Undoubtedly many of the concerns that employees express over drug testing arise from the invasiveness and unreliability of the screening technique, from the ways in which erroneous results could be used improperly, and the possibility of human error. Employers who fail to recognize these testing defects may find themselves defending invasion of privacy claims. Absent specific state or federal legislation, it is primarily the common-law torts comprising "invasion of privacy" that define the privacy rights of private employees. Although it may be possible to challenge successfully a drug testing program under several theories, the tort of intrusion has been suggested as the most applicable to employers' interference with employees' off-duty drug use.

The tort of intrusion protects against surreptitious surveillance and similar acts.³³ No court decision has been rendered in an intrusion action challenging a private employer's drug testing program. In a similar context, the U.S. Court of Appeals for the First Circuit in *O'Brien v. Papa Gino's of America*,³⁴ considered a common law privacy challenge to a polygraph test where an employee was suspected of using drugs outside work. A jury found that the company's allegations of drug use and use of a polygraph test violated the employee's common law right of privacy, and awarded him \$398,200. The issue presented to the jury was not whether the employer was justified in terminating an employee for off-duty drug use, but whether the methods used to investigate those allegations would be highly offensive to a reasonable person and were invasive of his privacy. Opponents of drug testing claim that the urinalysis procedure is equally offensive and intrusive, if not more so.

A second common law theory available is the tort of defamation. In *Houston Belt & Terminal Railway Co. v. Wherry*³⁵ an employee was discharged after an accident because urinalysis testing revealed traces of methadone, a substance commonly used to treat heroin addiction. A

physician consulted by the discharged employee undertook further urinalysis and discovered that the urine sample contained a compound which, although similar to it, was not methadone. Although advised of this result, the employer refused to reconsider the discharge decision. An internal accident report and a letter from the employer's director of labor relations repeated the allegation that the discharged employee was a recovering heroin addict. A jury awarded the former employee \$200,000 in damages for defamation. This employer might have avoided litigation by not announcing the "medical" conclusions and by establishing a policy of having an independent laboratory re-examine positive test results.

Discipline and Discharge for Drug and Alcohol Use

Drug testing is seldom, if ever, conducted without some prior consideration of what an employer intends to do with the test results. The many approaches and policies implemented in the private sector usually involve rehabilitation (often through an employee assistance program [EAP]), discipline, or discharge. Discharges based upon positive drug or alcohol test results face a variety of legal obstacles, including the status of drug addiction and alcoholism as handicaps under federal and some state rehabilitation acts.³⁶ Privacy issues arise where the employee argues that his drug use was limited to his personal time and did not impair his work performance. If an employer can show that drug or alcohol use impaired the employee on the job, the discharge decision will usually be upheld. Surveys of arbitration decisions reveal that, more often than not, arbitrators will not uphold discharges based upon off-the-job drug use.³⁷

A leading text on arbitration states that the right of management to discharge an employee for conduct away from the plant depends on the effect of that conduct upon plant operations, as where the behavior damages the employer's product or reputation, renders the employee unable to perform his duties or appear at work, or affects other employees' morale or willingness to work with the employee.³⁸ Where drug or alcohol tests are conducted based upon reasonable suspicion of substance abuse on the job and to confirm those suspicions of impairment, the termination will generally be upheld based on "reasonable suspicion" and positive test results, even in absence of direct proof of actual use on the job. One drawback to random or mandatory drug tests is that they can reveal the presence of certain drugs, including marijuana, days after use. An employer basing a discharge solely on this evidence may encounter difficulty proving that there was good cause for the discharge based upon off-duty drug use if there is no evidence of impaired or substandard job performance.

The U.S. Court of Appeals for the Fifth Circuit recently considered two arbitration decisions involving off-duty activities by employees of Union Oil. Both employees were discharged for use of illegal drugs. The dis-

charge of one employee for use and sale of drugs was sustained because he presented a safety risk. A different arbitrator ordered reinstatement of the other employee after finding him drug-free. The court held that the competing public policies against drug use and favoring rehabilitation were questions for the arbitrator, not the court, and that the reinstatement did not violate public policy.⁹

In non-unionized companies, employers who seek to regulate off-duty drug use by discharging employees who test positive for drugs face the potential for tort claims for invasion of privacy or a suit for wrongful discharge. While the case law is sparse, it is difficult for most employees to claim that they have legitimate rights to possess, sell, or use illegal drugs. As the Supreme Court stated in *United States v. Jacobsen*, "Congress has decided . . . to treat the interest in privately possessing cocaine as illegitimate."¹⁰ Yet employees have an argument that their employers are not entitled to inquire into their private lives at all. The employers' position is much more defensible, particularly where the regulation of off-duty drug use is tied to workplace problems or performance. Employers have an interest in ensuring that off-duty use of drugs or alcohol in no way disrupts or harms the work environment. It is unclear whether a discharge based upon illegal drug use *per se*, without evidence of impaired performance, violates public policy. If an employer has an express or implied just cause standard set out in policies or handbooks, there is a possibility that courts could follow the pattern set in arbitration decisions and force employers to show some negative impact on the workplace.

Guidelines for Employers

As is readily apparent from the controversial nature of drug testing, the number of privacy challenges to proposed or implemented drug screening is likely to increase. The law with respect to substance abuse policy is not well-developed and provides less than complete guidance to employers. The permissibility of a given policy will probably be determined on a review of the following factors:

Type of Position Covered

Courts and juries can more easily understand the importance of detecting drug and alcohol use among employees involved in public safety (airline pilots, truck drivers, police officers) and dangerous jobs involving electricity and machinery. Uniform testing of all employees and executives may also be viewed more favorably than testing that excludes management.

Standard for Testing

Random testing without notice has caused the greatest concern among most commentators. Mandatory testing, such as during an annual phys-

ical, is seen as less intrusive and less arbitrary. Testing that is limited to situations involving an individualized reasonable suspicion of on-the-job impairment is the most likely to withstand challenge.

Written Policies and Notice

Employers that have a carefully worded, comprehensive, written substance abuse policy and that have given full notice of that policy to applicants and employees have greater latitude than employers that act on the basis of ad hoc unwritten policies. These policies should set out the employer's policy on drug and alcohol use, state when and how testing will be conducted, and identify the penalties for negative results.

Procedural Protections

Employers that use qualified, experienced laboratories, careful labeling and chain-of-custody procedures, and provide appropriately sophisticated secondary tests to confirm results, have a better chance of defending actions taken on positive results.

Confidentiality of Results

Employers who insure that test results do not convey other private medical information, that no results are released or announced without confirmation testing, and that all results are conveyed only on a need-to-know basis, can limit the risk of defamation claims.

Standard Triggering Adverse Action

Employers can more easily justify adverse action for the on-the-job possession of quantities of an illicit drug or levels indicating impairment than they can for only trace amounts of alcohol or marijuana in a urine sample.

Type of Adverse Action

Employers that offer voluntary rehabilitation programs can more easily defend their substance abuse policies than employers that have no rehabilitation programs and automatically terminate employees for a first offense.

Whatever guidelines are ultimately established for employee drug screening, it is clear that the risk of suits is high. Employers should be careful to implement such programs in a manner that provides for notice of testing, review of results, confidentiality, and fairness in the application of tests.

3335985202

EXECUTIVE LEGAL SUMMARY

BUSINESS LAWS, INC.
8228 MAYFIELD ROAD
CHESTERLAND, OHIO 44026
Phone: 216-729-7996

EDITOR: W.A. HANCOCK

Executive Legal Summary No. 17

CONTENTS

The Medical Background... 1

What Are the Legal Issues?..... 2

What Are the Applicable Laws, and What Do They Say?..... 2

Miscellaneous Considerations..... 3

Summary of Key Points... 4

The Medical Background

A brief discussion of the medical concepts relating to AIDS is important, in that these distinctions serve as the basis for what employers can and cannot do. The term "AIDS" is sometimes used too broadly. There are actually three different but related stages.

1. **Seropositive.** These are people who test positively on the tests which show whether or not the AIDS antibody is present in the blood system. Generally, these people have no symptoms of any disease, and may or may not ever develop AIDS. Unfortunately, medical science has not yet discovered enough information to know even approximately how many people "convert" from seropositive to an actual AIDS condition. The current estimate is between 20-35%. The key point is that, while this estimate is high, it is less than 100%. Therefore, any employment decision based on the assumption that everyone who is seropositive will get AIDS and die

would be suspect.

2. **AIDS Related Complex (ARC).** These are seropositive people who have some of the clinical symptoms that may precede AIDS, such as weight loss or enlarged lymph glands, but who do not have the presence of the opportunistic infections or cancers which generally cause an AIDS patient to die. Opportunistic infections are those for which the viruses are generally present, but which normal people can resist because of their immune system. Again, medical science cannot tell us what percentage of those with ARC may convert to AIDS, but the estimate is higher than for those who are only seropositive.

3. **Acquired Immune Deficiency Syndrome (AIDS).** Sometimes these people are referred to as having "full blown AIDS" or "actual AIDS." These are the people who not only have clinical symptoms, which are usually either "opportunistic infections" or unusual cancers, but who also have the presence of a diminished immune system.

We can see that there is a spectrum, and that the lines between the various stages are by no means bright. When we ask what we can or should do from a legal perspective, we must be sure to focus separately on these three stages.

HTLV III/LAV

This is the medical term for the virus which the doctors are almost certain causes AIDS:

The Tests

Doctors test for the virus indirectly by testing the blood to see if the person has antibodies to the virus. The testing procedure is as follows. First, the doctors use an "ELISA" test, which is a public health test developed to screen blood so that AIDS is not transmitted by blood transfusion. If that test is positive, it is repeated. The key point is that this test was developed to give many "false positives," in other words, to err on the side of excluding any blood which *might* be infected. Since there are so many false positives even with two ELISA tests, the doctors administer a third test, known as the "Western Blot" test. If that is positive, we can be reasonably sure that the person has been exposed to HTLV III/LAV because the person has developed antibodies to that virus. The presence of those antibodies alerts us to the past exposure.

What is the medical significance of being seropositive (i.e., undergoing all three tests with all of them showing that you have the antibodies to the AIDS virus)? The doctors are unclear, but to be on the safe side, they say this.

1. We must assume that a seropositive person has been exposed to the AIDS virus and that the AIDS virus is still in that person's system, so that it is possible that he will progress from merely being seropositive to having ARC or AIDS. The AIDS virus, unlike most, remains in a person forever. The virus itself may never

2025865334

erupt into ARC or AIDS, but it never goes away.

2. We must assume that this person, since he may have the AIDS virus in his system, can transmit that virus to others.

How Is AIDS Transmitted?

The doctors universally agree that AIDS is transmitted primarily, if not almost exclusively, by intimate sexual contact, by the use of a contaminated needle (usually in the context of drug use), or by blood transfusion. **Casual contact does not transmit AIDS.**

However, and this is where we start running into controversy, the AIDS virus has been found in virtually all bodily fluids, including tears and saliva. Further, the disease is so new that the doctors are not in a position to **guarantee** that AIDS cannot be transmitted through less than intimate sexual contact. Since the doctors will guarantee one thing — AIDS is basically always fatal — we do have an AIDS hysteria because of the possibility, however remote, that it might be transmittable in a more casual way than the doctors now recognize.

The statistics clearly show that the odds are slim if not nonexistent of getting AIDS from other than intimate sexual contact, a blood transfusion, or sharing drug needles. Indeed, no such case is known to medical doctors (although there are some isolated cases in which the doctors cannot explain how the person got the AIDS).

AIDS Is Not a Homosexual Disease

Homosexual males are a "high risk group." However, AIDS is and has been spread in the heterosexual community, and the spread is bidirectional. Men can get it from women and women can get it from men.

How Is the AIDS Virus Killed Outside the Body?

Clorox diluted 1 to 10 or any similar substance, including Lysol, kills the virus. The AIDS virus dies easily outside the body.

What Are the Legal Issues?

Basically, there are four legal issues.

1. **Can an employer refuse to hire people who are seropositive, have ARC, or have AIDS?** The probable answers are no for seropositive and ARC victims. For AIDS, it depends on whether or not the person could reasonably be expected to do the job.

2. **Can (or should) an employer test all applicants or present employees for AIDS?** (In other words, can it require the ELISA and Western Blot tests as a condition of employment?) The answer is that an employer probably could, but it is not a good idea. An employer cannot take any action based on the results of the test and, thus, is only asking for legal trouble by conducting the test and having the results in its files.

3. **What can/should an employer do if there is coworker pressure,** i.e., how do we deal with the AIDS hysteria factor? The answer is that the employer should deal with the problem by education and persuasion, not by getting rid of the victim.

4. **What planning should be done, or what programs should be implemented in advance of the problem?** Most people recommend advance thought and an education program emphasizing that it is basically impossible to transmit AIDS in the work environment. Some recommend

that you stop at the advance thought. In other words, get an idea of what you would do, but do not take any specific steps unless or until you have a problem.

What Are the Applicable Laws and What Do They Say?

The most applicable laws are those dealing with discrimination against the handicapped. There are two sets of these laws. One set consists of federal laws which govern federal employers and government contractors — anyone receiving government funds. The other set consists of the state handicap laws, which vary widely.

The federal law defines a handicapped person as one who:

- (a) *has a physical or mental impairment which substantially limits one or more of such person's major life activities;*
- (b) *has a record of such impairment, or*
- (c) *is regarded as having such an impairment.*

The prevailing view is that a person who is seropositive, or who actually has ARC or AIDS, would qualify under this definition, although there are no cases deciding the issue. Thus, if you discriminate against such people in either your hiring or firing, and you are covered by this federal law, you could have a problem.

The state handicap laws sometimes simply copy the federal definition, sometimes use their own definition, and sometimes do not have any definition of "handicapped." One of the things we should be doing in our

advance planning is finding out what our own state laws may say about the definition of "handicap," and whether the definition might include seropositive, ARC, or AIDS.

The National Labor Relations Act

If workers engage in "concerted activity," they are protected by the National Labor Relations Act. This is true whether or not they are members of a collective bargaining unit. However, the NLRA does not protect joint activity for an illegal purpose. Therefore, if a group of employees joined together to ask for the removal of a person protected by federal or state handicap laws, the NLRA would not protect them if the relevant state law defined AIDS, ARC or seropositive as a handicap, or if the federal law applied to that workplace.

Employee Retirement Income Security Act (ERISA)

ERISA makes it illegal to discharge someone for making a claim against his retirement benefits, or for the purpose of preventing the person from making such a claim. Thus, if you fire a person who is seropositive, or who has ARC or AIDS in order to save the tremendous cost of treating him, that would be a violation of ERISA. The statutory words are as follows.

It shall be unlawful for any person to discharge, fire, suspend, expel, discipline or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of an employee benefit plan ... or for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan.

The ERISA definition of "benefit plan" is very broad and includes any health, disability, or life insurance program.

Antidiscrimination Laws

Our civil rights laws prohibiting discrimination in employment might also apply to a situation where AIDS was singled out as a reason for failure

to hire or other discriminatory actions. The logic would be that 75% (the majority) of AIDS sufferers are male, and males are a protected class. The cases finding males to be a protected class are those holding that airlines cannot discriminate against males who apply for flight attendant jobs simply because passengers would rather have stewardesses than stewards.

OSHA

The Occupational Safety and Health Act requires all employers to provide a place of employment which is free from recognized hazards. Given the medical evidence to date, it is highly unlikely that the simple presence of an AIDS, ARC or seropositive victim in the workplace would make it "hazardous."

Right of Privacy

Almost all state laws recognize the right of privacy, although the parameters of this right are unclear. The obvious problem with AIDS is that, because of both normal and hysterical concerns, disclosing the results of a seropositive test could make someone virtually unemployable. If the test results kept in the employer's files were to leak out to the wrong person, a serious invasion of privacy claim might result.

Unjust Dismissal Law

The current trend toward imposing liability on companies for "unjust dismissal" is relevant to the AIDS problem because of the AIDS hysteria factor. If the manager of a facility finds out that an employee is seropositive, or has ARC or AIDS, and then puts all of that person's possessions outside the office, scrubs down the office with Lysol, fires the person, and asks him not to come back onto the property, the company would be opened to an unjust dismissal suit.

Miscellaneous Considerations

What about Cost?

The employer's claim that it should be able to discharge or refuse to hire

a person who has AIDS or ARC or who is seropositive because of the high cost of health care, while certainly true in an economic sense, probably would not be upheld in court.

What about Coworker Preferences or Biases?

These probably would not be given effect by the court, based on a rationale similar to that used in the civil rights cases. You cannot refuse to hire males, females, or blacks, and so forth, based on coworker preferences, nor can you discriminate against them in any other way.

What about Protecting the AIDS Victim Himself?

This issue is a little unclear. Since AIDS is an impairment of the immune system, that means that a person with AIDS would be abnormally susceptible to infection. If the person were, for example, employed in a hospital or someplace else where there was a high likelihood of getting an infection from sources not normally hazardous to non-AIDS victims, it may be that the employer could, or even should, prohibit the person from working there. Certainly if the person's own doctor recommended against such employment, the employer would be protected.

What about Coworker Safety Concerns?

This is similar to the problem above. People with AIDS have or may develop very unusual infections, the most serious of which may be tuberculosis (Tb). Since the person with AIDS may have these rare illnesses and may transmit them to healthy workers, should not the employer be able to eliminate the AIDS-infected person from the workplace because of this potential problem?

Since the AIDS problem is so new, the doctors are not in universal agreement on this question. The prevailing view, however, is that an AIDS patient with these unusual infections or cancers really does not present a problem to healthy people because a

2025865336

healthy person's immune system would be effective against any germs transmitted.

The one exception is TB. It may be necessary or appropriate to have any known AIDS or ARC patients tested periodically for TB.

How Much Do We Have to Accommodate the AIDS Victim?

Some, but not much. The law would be the same as for any other handicap, so to some extent we make our own rules according to past practice. In general, however, the handicap laws protect only people who are "otherwise able to do the job." Thus, for a seropositive person, no accommodation would be necessary. For an ARC person, any accommodation would probably be slight and temporary and might, therefore, be required. For an AIDS person, however, we would have to look carefully at the job, and how AIDS affected this person. Being a virus, AIDS affects everyone differently. In general, courts have imposed only modest duties of accommodation. The courts do not require an employer to incur extra costs, or significant rescheduling, nor to burden other workers by requiring them to do a portion of the handicapped worker's job. The courts may require an employer to incur a *de minimis* amount of expense, or to provide other forms of accommodation such as allowing time off for treatment where that does not affect production and where it is allowed for other illnesses.

What about a Job with a Lengthy Training Period?

This is not quite as clear. Suppose you have a known seropositive, ARC or AIDS victim applying for a job with a lengthy learning curve, such as that of a pilot or a policeman, or a job involving an apprenticeship. The best judgment at this time is that the AIDS-infected person could be excluded, either by not hiring him or by taking him out of the training program when the AIDS was discovered. The seropositive person **probably** could not be excluded and, in the case of the ARC person, it would simply be too close to call without precise facts. The

basis for saying that you probably could not exclude the seropositive person comes from cases like *E.E. Black Ltd. v. Marshall*, 497 F. Supp. 1088 (1980), which held that you could not exclude from a construction job a person with congenital back problems. To exclude someone because of a handicap, you must be able to show that he is **presently unable to perform the job**, not merely that he would likely become unable to do so in the future. There was also a recent case involving Xerox where an obese person was held to be protected by the state's handicap laws. The fact that obese persons have higher than normal insurance claims and lower than normal life expectancy does not mean you can exclude them from a job that they are presently able to perform. Other relevant authority says that it is not proper to use sex segregated actuarial tables for employee benefits. No one disputes the fact that women live longer than men, but as a matter of policy, it is required that we use unisex actuarial tables in computing benefits based on life expectancy.

What about the Military?

Some employers are tempted to look to the military as a model. The military is planning to test all applicants and members for AIDS. Applicants who test seropositive will not be accepted. Those already in the military who test seropositive will be subject to monitoring.

However, the military situation is rather different from that of private industry. First, the military is required to vaccinate all personnel with a live smallpox vaccine. Someone with AIDS may very well have a severe problem with that! Second, the military feels that everyone on the battlefield should be a potential blood donor. A seropositive person should not be allowed to give blood to anyone.

When the military announced that it was going to adopt this program, it said that one of the reasons (indeed the first listed) was that it did not want to incur the costs of treating people with AIDS. That rationale, while not illegal for the military to use, probably would not hold

up for private industry.

What Do Hospitals Do?

Hospitals generally treat AIDS patients similarly to those with hepatitis (a liver disease which can be highly contagious). They separate the patient from others, and put signs on the patient's room stating that blood and secretion precautions should be used. This means that everyone going into the room washes his hands, wears gloves, and so forth.

What about Schools?

In some highly publicized cases, children with AIDS have been excluded from school based on state or local laws, which say that people with "communicable diseases" either cannot or should not be allowed in public school. The question is whether AIDS, being transmittable only by intimate sexual contact, is a communicable disease within the meaning of these laws. New York has recently ruled that it is not.

Summary of Key Points

1. The term "AIDS" actually covers three different stages: seropositive, ARC, and "full blown AIDS." These medical distinctions are important in that they serve as the basis for what employers can and cannot legally do.

2. The basic legal issues surrounding the AIDS problem relate to refusal to hire people with AIDS, testing of applicants and/or employees for AIDS, dealing with coworker pressure, and advance planning to deal with these concerns.

3. A broad range of laws may apply to protect the employee with AIDS, including federal and state handicap laws, the National Labor Relations Act, ERISA, the civil rights laws, state privacy laws, and unjust dismissal law.

4. Employers probably have a duty to accommodate the AIDS victim to the same extent as with any other "handicap," as long as the person is presently otherwise able to do the job. Most courts require only a *de minimis* amount of accommodation.

APPLICATION OF U.S. FAIR EMPLOYMENT LAWS TO TRANSNATIONAL EMPLOYERS IN THE UNITED STATES AND ABROAD

LAIROLD M. STREET*

Increasing numbers of firms conducting business in both the United States and other countries give rise to questions regarding the reach of U.S. fair employment laws to employment practices of foreign firms within the United States, of U.S. firms abroad, and regarding U.S. citizens employed abroad. Mr. Street considers three laws—the Age Discrimination Act of 1967, the Equal Pay Act of 1963, and Title VII of the Civil Rights Act of 1964—to assess their impact on employer-employee interactions, both within and outside the United States. Recognizing conflicting interests and concerns of employers and employees, he concludes that principles of sovereignty and comity are not incompatible with a global commitment to fair employment practices.

I. INTRODUCTION

Changing conditions of international trade have brought into focus the influence that U.S. fair employment laws—the Age Discrimination in Employment Act of 1967 (hereinafter the ADEA),¹ the Equal Pay Act of 1963 (hereinafter the EPA),² and Title VII of the Civil Rights Act of 1964 (hereinafter Title VII)³—have on the United States' trade re-

* Oberlin College, A.B. 1974; The Johns Hopkins University School of Advanced International Studies, M.A. 1976; Indiana University School of Law, J.D. 1981. The author has worked as a staff attorney with the U.S. International Trade Commission and is presently a staff attorney with the U.S. Equal Employment Opportunity Commission. The author thanks Professor Dee Pridgen of the University of Wyoming School of Law for her helpful comments on an earlier draft of this article. This article was written by Lairold M. Street in his private capacity. No official support or endorsement of the U.S. Equal Employment Opportunity Commission or any other agency of the U.S. Government is intended or should be inferred.

1. Pub. L. No. 90-202, 81 Stat. 602 (1967) (codified as amended at 29 U.S.C. §§ 621-634 (1982 & Supp. III 1985)).

2. Pub. L. No. 88-38, § 3, 77 Stat. 56, 56-57 (1963), 29 U.S.C. § 206(d) (1982).

3. Pub. L. No. 88-352, tit. VII, §§ 701-716, 78 Stat. 241, 253-57 (1964) (codified as amended at 42 U.S.C. §§ 2000e to 2000e-17 (1982)).

lations with its trading partners.⁴

Although the United States and other countries have enacted employment laws primarily to protect their own nationals, the laws often affect foreign citizens and businesses as well. For this reason, these policies may intervene in economic relations between countries. The employment practices of transnational employers and the laws of their "corporate homes" are thus becoming new and important variables in the debate over restraint of trade between nations.

Recent attention given to the extraterritorial application of the ADEA, the EPA, and Title VII to transnational employers⁵ stems, at least in part, from a concern that foreign policy may overshadow and conflict with the statutory rights of U.S. citizens. Both the steadily rising number of transnational employers and the potential for conflict between different countries' commercial and economic laws have made regulating the transnational employer increasingly important.

Over 2000 U.S. firms operate more than 21,000 foreign subsidiaries in at least 121 foreign nations.⁶ In the United States, over 1700 foreign-owned firms employ more than 2.5 million Americans.⁷ Since U.S. businesses rely on foreign employees in their worldwide operations, the United States

4. The broad field of international trade encompasses many types of exchanges, including the sale of products and the exchange of human resources. The growth of foreign banking in the United States corresponds to an increase in the volume of foreign trade and investment in this country. See *Foreign Managers Make a Hit with U.S. Workers*, U.S. NEWS & WORLD REP., Jan. 8, 1979, at 59. These developments have additionally led to a substantial increase in the number of Americans employed by partially foreign owned businesses operating in the United States, a number that has now reached at least 1.5 million.

5. See Note, *Commercial Treaties and the American Civil Rights Laws: The Case of Japanese Employers*, 31 STAN. L. REV. 947 (1979); Note, *The Multinational Corporation and Employment Discrimination: A Strategy for Litigation*, 16 U.S.F.L. REV. 491 (1982). See generally *Sumitomo Shoji Am., Inc. v. Avagliano*, 457 U.S. 176 (1982); *Spiess v. C. Itoh & Co. (Am.)*, 469 F. Supp. 1 (S.D. Tex. 1979), *rev'd*, 643 F.2d 353 (5th Cir.), *reh'g granted en banc*, 654 F.2d 302 (5th Cir. 1981), *reh'g vacated en banc*, 664 F.2d 480 (5th Cir.), *vacated*, 454 U.S. 1130 (1982); *Linskey v. Heidelberg E., Inc.*, 470 F. Supp. 1181 (E.D.N.Y. 1979).

6. *Introduction to 1 WORLD TRADE ACADEMY PRESS, DIRECTORY OF AMERICAN FIRMS OPERATING IN FOREIGN COUNTRIES* (10th ed. 1984).

7. U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, SERIES FOF, No.

can appreciate the need for an open policy in this nation toward transnational employers. This does not imply, however, that transnational employers should be allowed to ignore U.S. fair employment laws.

A U.S. transnational employer of U.S. citizens outside the United States generally has a duty to follow both U.S. and foreign law. Similarly, a foreign employer of U.S. citizens outside the United States has a duty to treat its U.S. employees fairly, but its obligation under U.S. fair employment laws may not be as extensive as that of a U.S. employer. While the U.S. Supreme Court has stated that an "act of congress ought never to be construed to violate the law of nations if any other possible construction remains"⁸ and that courts should avoid creating international problems with foreign governments,⁹ determination of which nation's law applies to a transnational employer includes a variety of considerations: where the employee actually applied for employment; where the alleged discriminatory practice took place; where the employee's workplace is located; and where the business operates. More than one country may claim jurisdiction over the employer's practices. There may exist occasions when the ADEA, the EPA, or Title VII is irreconcilable with the laws of the host country in which a U.S. company is operating. The converse may also be true of a foreign transnational employer operating in the United States: U.S. laws may be irreconcilable with the laws of its home country. Foreign and U.S. firms share common concerns as transnational employers: if firms are to operate freely outside their own corporate homes, international agreement on common standards governing the employment practices of transnational employers is necessary.

One management consideration of the transnational employer in deciding where to locate operations is whether it can function without undue interference from the United States and its laws.¹⁰ Allowing transnational employers op-

6. *SELECTED CHARACTERISTICS OF FOREIGN-OWNED U.S. FIRMS: 1982*, at 1-2 (1984).

8. *McCulloch v. Sociedad Nacional de Marineros de Honduras*, 372 U.S. 10, 21 (1963) (quoting *The Charming Betsy*, 6 U.S. (2 Cranch) 64, 118 (1804) (Marshall, C.J.)).

9. See *id.* at 17.

10. Jensen, *Japanese-Style Work Code Works in America, Too*, Cleveland

6835985202

erating in the United States to dodge national fair employment laws, however, could lead to distressing results, as evidenced by a recent study of Japanese investors and managers operating in the United States.¹¹ The study, by a visiting scholar at the Harvard University Graduate School of Business Administration, reports that Japanese officials believe a commercial trade agreement insulates them from U.S. fair employment laws.¹² The study discloses that Japanese managers in the United States prefer to hire young employees, considering them more malleable and team-oriented, and thus more suitable, than older workers.¹³ The study also reveals a preference on the part of the Japanese to locate in rural or suburban areas in the belief that the more homogeneous populations of these areas leads to higher employee production.¹⁴ Such management decisions raise important questions, including whether they violate U.S. fair employment laws and whether they have the purpose or effect of discriminating against protected persons in the United States.

The possibility of a new kind of trade barrier arises when countries compete to protect their own corporations or citizens in the international workplace, notwithstanding the corporate home of the employer.¹⁵ Countries have always shown interest in regulating international commerce while trying to reconcile domestic laws with customary rules of international trade, as at least one scholar has pointed out:

[F]or a long time international commerce was understood and interpreted as an exchange between nationals and not between nations. But . . . the states have always been called upon to direct, coor-

Plain Dealer, Mar. 13, 1983, at 1-E, col. 1. Not only are foreign firms engaged in potentially unlawful employment practices in the United States, but U.S. firms may also be engaged in questionable employment practices as well. A *New York Times* article discloses that some U.S. firms may be eliminating communities from consideration when selecting location sites for their businesses if those communities have a large Black population. *N.Y. Times*, Feb. 15, 1983, at A14, col. 1.

11. See Jensen, *supra* note 10, at 9, col. 1.

12. *Id.*

13. *Id.*

14. *Id.*

15. C.M. SCHMITTHOFF, *THE SOURCE OF LAW OF INTERNATIONAL TRADE* 228 (1964).

dinate and arbitrate in the activities of merchants, companies and firms, and to oppose them if their development was prejudicial to the foundations of its economic policy. This has become even more true as world commerce and technical progress have expanded. This is why one can admit that international commerce is not merely a transaction between individuals or firms of different nationalities, but is a real transaction between nations, where exchanges are effected, guided and maintained by political decisions taken by the responsible governments of these nations.¹⁶

Thus, countries can be expected to protect their national economic interests through legislation when corporations threaten these interests. A good example is the Congressional enactment of the ADEA, the EPA, and Title VII for the protection of U.S. citizens, who constitute an increasing number of transnational employees.

Historically, few U.S. employees successfully persuaded U.S. courts to apply U.S. fair employment laws to their overseas transnational employers. Congress, however, has recently amended the ADEA in order to offer a remedy to a U.S. citizen employed by a transnational entity. Consequently, U.S. courts now have a great deal of discretion and flexibility in deciding how to apply the ADEA, as well as the EPA and Title VII, as a matter of both domestic and international law.

Traditional legal jurisprudence has seldom examined employment practices of transnational employers in the context of broader international trade issues. Because little attention has been given to the overlap between the two fields and each one's effect upon the other, the area is a new frontier for studies in trade and transnational employment practices.

This Article first examines whether U.S. fair employment laws can be appropriately applied to U.S. or foreign transnational employers abroad. It analyzes the nature and the limits of power that a nation can legitimately exercise over its own citizens and companies and over foreign citizens

16. *Id.*

0hE598520Z

and companies in other countries. The Article then considers the two questions that U.S. courts must resolve whenever there are potentially conflicting laws in this area: (1) whether Congress intended each of the three fair employment laws to apply to transnational employers, operating either within the United States or abroad, and (2) whether the broad application of these laws to transnational employers acts as a restraint on trade or violates international law, regardless of Congressional intent.

Part II of this Article traces the statutory development and case law on the application of the ADEA, the EPA, and Title VII to transnational employers. Part III explores the conceptual and practical difficulties of applying these statutes to transnational employers; it examines the international framework of laws, treaties, and international agreements that encourage transnational employers to practice nondiscrimination in employment and addresses some conflict of laws principles that apply when the expectations, traditions, and interests of more than one country must be considered in resolving trade disputes in employment. Part IV reexamines the three statutes and discusses some of the procedural and substantive issues awaiting litigants at the administrative and judicial levels. Finally, Part V addresses the role of the international community in adopting uniform standards to cover employment practices of the transnational employer.

II. EXTRATERRITORIAL APPLICATION OF U.S. FAIR EMPLOYMENT LAWS

Congressional intent in enacting a statute determines whether the law shall operate extraterritorially: "the canon of [statutory] construction . . . teaches that legislation of Congress, *unless a contrary intent appears*, is meant to apply only within the territorial jurisdiction of the United States."¹⁷ If it wishes to do so, Congress has the power to

17. *Foley Bros. v. Filardo*, 336 U.S. 281, 285 (1949) (paraphrasing *Blackmer v. United States*, 284 U.S. 421, 437 (1932)) (emphasis added). Congress has the power, in certain situations, to regulate the actions of U.S. citizens outside the territorial jurisdiction of the United States whether or not the acts prescribed occurred within the territory of a foreign country. See *United States v. Bowman*, 260 U.S. 94, 99 (1922). Legis-

enact legislation that applies beyond U.S. borders. Consistent with this canon of statutory construction, the extraterritorial applicability of U.S. fair employment laws is as follows: the ADEA has extraterritorial application by virtue of a specific amendment, the EPA at present has limited extraterritorial reach, and Title VII has implied extraterritorial reach as expressed in the statute's legislative history and judicial interpretation.

A. ADEA

1. *The ADEA Prior to Its 1984 Amendment*

The ADEA prohibits age-related discrimination in employment against persons over the age of forty.¹⁸ Prior to the 1984 Congressional amendment of the ADEA,¹⁹ several U.S. courts had held that the ADEA did not apply extraterritorially and, therefore, did not apply to U.S. citizens working for U.S. corporations in a foreign country.²⁰

The ADEA incorporates by reference 29 U.S.C. § 213(f)

lation that regulates actions of U.S. citizens and corporations should not infringe upon the sovereignty of another nation. See *Skiriotes v. Florida*, 313 U.S. 69, 73 (1941). Moreover, any liabilities created by statutory regulation of employment practices must satisfy the notions of fairness and substantial justice under the Due Process Clause of the U.S. Constitution.

18. 29 U.S.C. § 631(a) (1982), as amended by Pub. L. No. 99-592, § 2(c) (1986).

19. Older Americans Act Amendments of 1984, Pub. L. No. 98-459, § 802, 98 Stat. 1767, 1792, 29 U.S.C. §§ 623(g), 630(f). Congress erroneously mislabelled the amendment to 29 U.S.C. § 623; as the statute presently reads, there are two subsection (g)'s. To distinguish between the original subsection and the new subsection, all references in this Article to the new subsection have the letter *g* italicized. Thus, 29 U.S.C. § 623(g) refers to the new amendment, while 29 U.S.C. § 623(g) refers to the original, still existing subsection.

20. *Ralis v. RFE/RL, Inc.*, 770 F.2d 1121 (D.C. Cir. 1985); *De Yoreo v. Bell Helicopter Textron, Inc.*, 608 F. Supp. 377 (N.D. Tex. 1985), *aff'd*, 785 F.2d 1282 (5th Cir. 1986); *Belanger v. Keydril Co.*, 596 F. Supp. 823 (E.D. La. 1984), *aff'd*, 772 F.2d 902 (5th Cir. 1985); *Cleary v. United States Lines, Inc.*, 555 F. Supp. 1251 (D.N.J. 1983), *aff'd*, 728 F.2d 607 (3d Cir. 1984); *Pfeiffer v. Wm. M. Wrigley Jr. Co.*, 573 F. Supp. 458 (N.D. Ill. 1983), *aff'd*, 755 F.2d 554 (7th Cir. 1985); *Zahourek v. Arthur Young & Co.*, 567 F. Supp. 1453 (D. Colo. 1983), *aff'd*, 750 F.2d 827 (10th Cir. 1984). The ADEA amendment is not retroactive in effect and thus does not apply to ADEA actions initiated before its enactment. *Wolf v. J.I. Case Co.*, 617 F. Supp. 858, 867 (D. Wis. 1985).

145985202

of the Fair Labor Standards Act (hereinafter the FLSA),²¹ which provides that U.S. citizens working in foreign countries are not entitled to its statutory protection.²² The impact of 29 U.S.C. § 213(f) on ADEA enforcement used to be substantial: a fifty-year old U.S. citizen employed by a U.S. corporation in the United States who was then transferred permanently to an overseas office of his employer and was subsequently discharged abroad for "poor supervisory skills" would have received little help from the ADEA in any age discrimination suit he might have brought against his U.S. employer. Section 213(f) reads as follows:

The provisions of . . . this title shall not apply with respect to any employee whose services during the workweek are performed in a workplace within a foreign country²³

The hypothetical employee comes within this description. Thus, in short, the pre-1984 ADEA would have covered neither the employer nor the employee abroad, even though both were U.S. nationals.

2. *The 1984 ADEA Amendment*

In 1984, Congress strengthened the ADEA by expanding its territorial application to reach certain businesses and employees located abroad. The amendment achieved this result by broadening the definition of "employee." A House Conference report states that the amendment changes the ADEA "by specifying that the term 'employee' under the Act includes any individual who is a citizen of the United States employed by a United States employer in a foreign country."²⁴

The ADEA amendment was intended to give U.S. citizens employed abroad by U.S. corporations or their subsidi-

21. 29 U.S.C. §§ 201-214 (1982 & Supp. III 1985).

22. *Id.* § 213(f). 29 U.S.C. § 626(b) states that the enforcement of the ADEA shall be performed in accordance with the provisions of 29 U.S.C. § 211(b), which is part of the Fair Labor Standards Act. See *Vasquez v. Eastern Air Lines, Inc.* 579 F.2d 107, 109 (1st Cir. 1978). Section 211(b) is, in turn, limited in its scope by 29 U.S.C. § 213(f).

23. 29 U.S.C. § 213(f) (1982).

24. H.R. CONF. REP. NO. 1037, 98th Cong., 2d Sess. 49 (1984), reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 2974, 3037.

aries or foreign companies controlled by U.S. firms the same protection given to citizens employed in the United States. The Senate Labor and Human Resources Committee emphasized that, in amending the ADEA, it had taken into account

the well-established principle of sovereignty, that no nation has the right to impose its labor standards on another country. That is why the amendment is carefully worded to apply only to citizens of the United States who are working for U.S. corporations or their subsidiaries. It does not apply to foreign nationals working for such corporations in a foreign workplace and it does not apply to foreign companies which are not controlled by U.S. firms.²⁵

The legislative history does not specifically indicate when a foreign subsidiary is covered by the ADEA—whether, for example, the foreign subsidiary must maintain certain types of contacts with the United States. Yet the amendment and the legislative history do indicate that the ADEA now extends to the practices of a U.S.-controlled foreign company. The statute now provides as follows:

(1) If an employer controls a corporation whose place of incorporation is in a foreign country, any practice by such corporation prohibited under this section shall be presumed to be such practice by such employer.

(2) The prohibitions of this section shall not apply where the employer is a foreign person not controlled by an American employer.²⁶

The statute provides four factors to be considered in assessing the degree of control a U.S. business or employer exerts over a foreign firm. This "degree of control" test involves an assessment of the interrelation of operations, common management, centralized control of labor relations, and common ownership or financial control.²⁷ The factors im-

25. S. REP. NO. 467, 98th Cong., 2d Sess. 27-28 (1984), reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 2974, 3000-01.

26. 29 U.S.C. § 623(g)(1)-(2) (Supp. III 1985).

27. *Id.* § 623(g)(3)(A)-(D).

2025985202

plicitly require considerable contacts between the foreign company and the United States.

The amendment also reflects Congressional concern regarding potential conflicts between the ADEA and the laws of other countries. The amendment specifically excludes application of the ADEA where compliance would cause an employer to "violate the laws of the country in which such workplace is located."²⁸ With the 1984 amendment, Congress took a major step toward extending U.S. fair employment laws to employment relations between U.S. workers and their employers abroad.

B. EPA

The EPA, added in 1963 to the minimum wage provisions of the FLSA, prohibits sex-based wage discrimination in the workforce.²⁹ Unlike the ADEA, the EPA's territorial scope remains statutorily confined to the United States.³⁰ In certain situations, however, the FLSA and, consequently, the EPA do apply to persons working outside the United States and provide these persons with a remedy against gender-based wage discrimination. Courts have given the FLSA extraterritorial application in at least two situations: where an employee works in an area under U.S. control,³¹ and where an employee works only a portion of the workweek outside of the United States.³²

The question of the FLSA's application in areas under U.S. control arose in *Vermilya-Brown Co. v. Connell*,³³ prior to the EPA's enactment. There, U.S. citizens employed by a U.S. Government contractor on a military base leased to the United States in Bermuda brought suit under the FLSA to recover unpaid overtime compensation and damages.³⁴ The U.S. Supreme Court held that the FLSA applied to employees at the Bermuda base.³⁵ The Court had no doubt that

28. *Id.* § 623(f)(1).

29. *Id.* § 206(d)(1) (1982).

30. *Id.* § 213(f).

31. See *Vermilya-Brown Co. v. Connell*, 335 U.S. 377 (1948).

32. See *Wirtz v. Healy*, 227 F. Supp. 123, 129 (N.D. Ill. 1964).

33. 335 U.S. 377 (1948).

34. *Id.* at 378-79.

35. *Id.* at 390.

Congress possessed the power to regulate contracts when the incidents regulated occurred in areas under U.S. control though not within its territorial jurisdiction or sovereignty.³⁶ Following the *Vermilya-Brown* decision, Congress expressed dissatisfaction with the holding by passing an amendment to the FLSA in 1957 designed to exclude from coverage work performed within a foreign country.³⁷

The second situation in which the EPA has been applied beyond the boundaries of the United States is one where an individual performs services both within the United States and within a foreign country during any workweek. In *Wirtz v. Healy*,³⁸ a district court applied the FLSA, including the EPA provisions within it, to tour guides who were employed by a Chicago-based agency and who worked in both the United States and either Canada or Europe in the course of a workweek.³⁹ The court concluded that when an American employee spends part of the workweek in the United States, "it makes no difference where the remainder of such work in that week is performed."⁴⁰ The court held that the 1957 amendment passed in response to the *Vermilya-Brown* decision did not bar a court from applying the FLSA to the tour guides so long as they worked a portion of a workweek within the United States.⁴¹ The amendment did, however, bar a court from applying the FLSA for any week spent entirely outside the United States.⁴²

In sum, although the 1957 amendment of the FLSA restricts the extraterritorial application of that particular statute, including its EPA provisions, the restriction does not operate as a strict prohibition for employees with a "split" workweek.

36. *Id.* at 381; see also Green, *Applicability of American Laws to Overseas Areas Controlled by the United States*, 68 HARV. L. REV. 781 (1955).

37. S. REP. NO. 987, 85th Cong., 2d Sess., reprinted in 1957 U.S. CODE CONG. & ADMIN. NEWS 1756. The amendment passed was the Fair Labor Standards Amendment of 1957, Pub. L. No. 85-231, 71 Stat. 514, 29 U.S.C. § 213(f) (1982).

38. 227 F. Supp. 123 (N.D. Ill. 1964).

39. *Id.* at 129.

40. *Id.*

41. *Id.*

42. *Id.*

C. Title VII

Unlike the ADEA and the EPA, Title VII does not, with one exception, explicitly state whether it is to be given extra-territorial application. Instead, one must infer Congress' implied intent to apply Title VII to U.S. citizens employed by foreign corporations within the United States or by U.S. or foreign transnational corporations abroad and to foreign citizens employed by U.S. or foreign corporations within the United States.

The only explicit statutory reference about any extraterritorial application of the statute is in section 702, which states that the statute does not cover aliens working outside the United States.⁴³ In an early decision, the EEOC dealt with a discrimination charge by a resident alien against a U.S.-based multinational corporation stemming from a "no rehire" reference sent from an affiliate company located abroad for whom the employee had previously worked. The Commission concluded that:

[T]he alleged discriminatory act . . . took place with respect to the employment of an alien outside the United States. Title VII does not apply to events occurring under these circumstances even though the employment relationship is between an alien and an employer within the meaning of Section 701(b) of Title VII. Charging Party, an alien, was both employed and hired outside the United States. Such employment is exempted from Title VII coverage by Section 702.⁴⁴

While both this case and section 702 indicate that Title VII does not cover non-U.S. citizens who work abroad, even if the employer is a U.S. national, no inference should be drawn that this rule applies either to American employees either within the United States or abroad or to American or foreign employers with regard to their employees in the United States.

To be subject to the provisions of Title VII, a defendant must be an "employer" as defined by Title VII. Section

43. 42 U.S.C. § 2000e-1 (1982).

44. EEOC Dec. No. 71-1811, Empl. Prac. Guide (CCH) ¶ 6239, at 4426 (1971).

701(b) defines an employer as a "person engaged in an industry affecting commerce who has fifteen or more employees for each working day of twenty or more calendar weeks in the current or preceding calendar year."⁴⁵ The statute does not explicitly state that foreign commerce is included within "commerce." Yet it does state that "commerce" includes commerce between a "State and any point outside thereof."⁴⁶ During the House debates, Congressman Libonati suggested that the Title VII provisions were necessary to remove obstacles from the free flow of commerce among the states and with foreign countries.⁴⁷ Congressman Libonati concluded that "Title VII covers employers engaged in industries affecting commerce—interstate, foreign commerce, and commerce within the District of Columbia and the possessions."⁴⁸

By intending the statute to cover employers engaged in foreign commerce, Congress must have meant Title VII to extend both to U.S. employers operating abroad and to foreign employers operating in the United States. The text of section 703 of Title VII supports this broad interpretation. Section 703 prohibits discrimination against "any individual" with respect to his or her employment.⁴⁹ Section 702 contains the only exception to this provision by excluding aliens working outside the United States from Title VII protection.

Nowhere does Title VII explicitly exempt foreign corporations employing U.S. citizens either within or outside the United States. Drawing on the rule that courts should construe statutory exemptions narrowly, some courts have interpreted section 702 as containing a "negative implication" that Congress did not intend to place territorial limits on the

45. 42 U.S.C. § 2000e(b). Similarly, section 11(b) of the ADEA defines an employer as having 20 or more employees for a similar duration. 29 U.S.C. § 630(b). Congress did not clearly indicate whether U.S. citizens or aliens employed outside the United States are to be counted toward the requisite number of employees to qualify as an employer under either statute.

46. *Id.* § 2000e(g).

47. See 110 CONG. REC. H2737 (daily ed. Feb. 10, 1964) (statement of Rep. Libonati).

48. *Id.*

49. 42 U.S.C. § 2000e-2(a).

HH5985202

protection of U.S. citizens.⁵⁰ For example, in *Love v. Pullman Co.*,⁵¹ a district court held that American porters employed in Canada by Pullman, a U.S. corporation, were protected by Title VII.⁵² In the same vein, citing the language of section 702, *Bryant v. International Schools Services, Inc.*,⁵³ and *Love*, the EEOC has concluded that Title VII "does apply to covered employers with respect to their employment of U.S. citizens outside the United States."⁵⁴ In reaching its decision, the Commission stated that the "only exceptions to prohibitions against discrimination are those specifically enumerated in" Title VII.⁵⁵

In sum, Title VII must be construed to exempt neither foreign nor U.S. employers from coverage for American employees abroad or for any employees in the United States. This broad interpretation of Title VII is consistent with its remedial purpose, namely, the removal of barriers that operate against certain classes of employees.⁵⁶

D. Differing Application of the ADEA and Title VII in the Workplace Abroad

In contrast to the broad application of Title VII to employment practices of employers abroad, the recent amendment to the ADEA may possibly prohibit discrimination by employers abroad only against persons whom they already employ, for the 1984 ADEA amendment redefined the term "employee" to include an American employed outside the United States.⁵⁷ An American living abroad who seeks em-

50. See *Bryant v. International Schools Serv., Inc.*, 502 F. Supp. 472, 482 (D.N.J. 1980), *rev'd on other grounds*, 675 F.2d 562 (3d Cir. 1982); *Love v. Pullman Co.*, 12 Empl. Prac. Dec. ¶ 11,225 (D. Colo. 1976), *aff'd*, 569 F.2d 1074 (10th Cir. 1978). But see *American Banana Co. v. United Fruit Co.*, 213 U.S. 347, 357 (1909).

51. 12 Empl. Prac. Dec. ¶ 11,225 (D. Colo. 1976), *aff'd*, 569 F.2d 1074 (10th Cir. 1978).

52. *Id.* at 5688 n.4.

53. 502 F. Supp. 472, 482-83 (D.N.J. 1980), *rev'd on other grounds*, 675 F.2d 562 (3d Cir. 1982).

54. EEOC Dec. No. 85-16, 2 Empl. Prac. Guide (CCH) ¶ 6857, at 7072 (Sept. 16, 1985).

55. *Id.*

56. See *Griggs v. Duke Power Co.*, 401 U.S. 424, 429-30 (1971).

57. See *supra* text accompanying note 24.

ployment abroad with a U.S. employer may, therefore, be protected under Title VII but not under the ADEA.

Title VII prohibits discrimination against both present employees and applicants for employment.⁵⁸ The ADEA, by contrast, may not extend to employment-related practices. Although the legislative history of the ADEA does not provide conclusive evidence that Congress actually intended this result, the language of the amendment strongly supports this interpretation. Yet it is possible to interpret the ADEA otherwise. It is arguable that Title VII and the ADEA cover all types of discriminatory employment practices abroad, regardless of whether the person bringing the Title VII or ADEA action is a current employee or an applicant for employment. This interpretation is reasonable because the ADEA and Title VII are coextensive: Congress patterned the ADEA after Title VII, and both statutes are based on similar principles.⁵⁹ By amending the ADEA so that it could apply to U.S. citizens in the workplace abroad, Congress may have sought to put the ADEA on the same footing as Title VII in all respects concerning extraterritorial coverage. It remains uncertain, however, whether Congress truly intended either Title VII or the ADEA to apply this broadly.

III. LIMITS ON THE EXTRATERRITORIAL APPLICATION OF THE ADEA, THE EPA, AND TITLE VII

Claims brought under the ADEA, the EPA, or Title VII involving transnational employers often raise questions that go beyond rules governing the employer-employee relationship. They require courts to consider choice of law and conflict of laws questions. Prior to deciding a particular case on its merits, a judicial or administrative body must decide whether, for foreign policy or other reasons, it would be appropriate for the body to exercise its authority in the matter and, if so, which country's law should apply.⁶⁰ Specifically, these questions address the applicability of the ADEA, the EPA, or Title VII to U.S. corporations operating abroad, to

58. See 42 U.S.C. § 2000e-2(a).

59. See *Oscar Mayer & Co. v. Evans*, 441 U.S. 750, 756 (1979); *Lorillard v. Pons*, 434 U.S. 575, 584 (1978); *Hodgson v. First Fed. Sav. & Loan Ass'n*, 455 F.2d 818, 820 (5th Cir. 1972).

60. See sources cited *supra* notes 5 & 15.

foreign employers operating in the United States, to foreign citizens employed in the United States, and to U.S. citizens employed abroad. Resolution of these questions requires courts to look both to applicable principles of international law and to relevant treaties in force.

To resolve a conflict of laws or choice of law problem, one must examine the international rules governing the interaction between the laws of two or more states. The bases for these rules involve the doctrines of sovereignty and comity.⁶¹ The doctrine of sovereignty indicates that the laws and judgments of a country have no obligatory authority or effect beyond that country's own territorial limits. Nevertheless, one country may choose to give effect to the laws of another under the doctrine of comity of nations.

The term "sovereignty" expresses a nation-state's right to exercise absolute political and legal authority over all persons and property within its territory. Sovereignty can be conceived of as either external or internal; internal sovereignty being the inherent right of a people to govern their internal affairs; and external sovereignty consisting of the power of a national government in its dealings with the outside world to assert its political influence independent of any other nation.⁶²

The doctrine of comity reflects the efforts of two countries to defer to international friendship and convenience while still protecting the rights of their own citizens. Under the doctrine of comity, there is no requirement that one country must recognize the laws and judgments of another; recognition is a matter of courtesy rather than a right or obligation.⁶³ Thus, determining the issue of the ADEA's, the EPA's, or Title VII's extraterritorial reach must involve an analysis of factors beyond the mere terms of the laws themselves. The principles of sovereignty and comity require that adjudicating bodies consider whether the foreign employer

61. See *Hilton v. Guyot*, 159 U.S. 113, 135-36 (1895); see also *Cleary v. U.S. Lines, Inc.*, 555 F. Supp. 1251 (D.N.J. 1983), *aff'd*, 728 F.2d 607 (3d Cir. 1984); Cardozo, *Judicial Deference to State Department Suggestions: Recognition of Prerogative or Abdication to Usurper?*, 48 CORNELL L.Q. 461, 468-69 (1963).

62. See *United States v. Belmont*, 301 U.S. 324, 330 (1937).

63. Lorenzen, *Story's Commentaries on the Conflict of Laws—One Hundred Years After*, 48 HARV. L. REV. 15 (1934); see also *Belmont*, 301 U.S. at 330.

has business contacts with the United States, whether a treaty agreement with the United States permits the extraterritorial application of U.S. laws, and whether a foreign government or employer actually consented to be subject to U.S. fair employment laws.

The extraterritorial application of the ADEA, the EPA, or Title VII may in some cases be affected by international limitations, customarily observed by nations, upon each nation's exercise of power. The laws and public policies of competing governments, the allegiances or nationalities of the parties, the situs of the acts complained of, the general needs of the interstate and international community, and other conflict of laws and choice of law factors may come into play.⁶⁴ Failure to observe the relevant factors would contravene an established principle of international law: "The laws of no nation can justly extend beyond its own territories, except so far as regards its own citizens. They can have no force to control the sovereignty or rights of any other nation, within its own jurisdiction."⁶⁵ In an action by a U.S. citizen against a transnational employer, U.S. courts must not violate the situs country's sovereignty by interfering with that country's internal affairs.⁶⁶

Although the application of the ADEA, the EPA, or Title VII may in a given situation extend to a transnational employer, other considerations—such as commercial ties between countries or potential foreign policy ramifications—may compel an administrative or judicial body in the United States to refrain from exercising its jurisdiction in a particular case. In deciding whether to exercise their authority, U.S. courts and officials must weigh U.S. laws against competing laws, public policies, and governmental interests of foreign countries. A Texas court, for instance, held that an American helicopter pilot's employment by a U.S. contractor in Saudi Arabia could be conditional, consistent with Title VII, on the pilot's conversion to Islam where Saudi law permitted only Moslems to fly over Mecca.⁶⁷ Another court, by con-

64. See Cardozo, *supra* note 61, at 469.

65. *The Apollon*, 22 U.S. (9 Wheat.) 362, 370 (1824).

66. *Cf. The Schooner Exchange v. M'Faddon*, 11 U.S. (7 Cranch) 116, 136 (1812) (Marshall, C.J.).

67. *Kern v. Dynallectron Corp.*, 577 F. Supp. 1196 (N.D. Tex. 1983).

trast, ruled that a U.S. employer that excluded Jewish doctors from a unit stationed in Saudi Arabia had violated Title VII despite a Saudi policy to boycott Israel.⁶⁸

Similarly, the existence of a treaty may demand that a court not enforce the ADEA, the EPA, or Title VII. When a conflict arises between a treaty and a prior federal statute, the treaty will supersede the inconsistent prior federal law.⁶⁹ If a treaty conflicts with a subsequent act of Congress, however, the act of Congress will generally only supersede the treaty if Congress clearly expressed an intent to override the treaty or any of its provisions.⁷⁰ Bilateral and multilateral treaties exempting transnational employers from coverage under U.S. laws are two types of treaties relevant to the application of the ADEA, the EPA, and Title VII.

Although foreign corporations present in the United States are not immune from U.S. fair employment laws, foreign governments and their agents party to a multilateral treaty may be immune under either U.S. or international law.⁷¹ For instance, the Vienna Convention on Diplomatic

aff'd, 746 F.2d 810 (5th Cir. 1984). The employer fired the American pilot when he decided not to convert. The court found that the pilot was aware of the requirement to convert to the Moslem faith; it held conversion to the Moslem faith to be a bone fide occupational qualification (BFOQ) and thereby was able to avoid a sticky conflict of laws question. The court concluded that the American contractor did not violate Title VII.

68. *Abrams v. Baylor College of Medicine*, 581 F. Supp. 1570 (S.D. Tex. 1984). In *Abrams*, a Title VII case, the court found that a U.S. employer that excluded its Jewish doctors from rotation to Saudi Arabia in accordance with an Arab trade boycott of Israel had discriminated against the Jewish doctors because of their religion. *Id.* at 1579. A similar state case held that an employer could not refuse to hire Jewish engineers because of Saudi Arabia's religious tenacity. *American Jewish Congress v. Carter*, 9 N.Y.2d 223, 173 N.E.2d 778, 213 N.Y.S.2d 60 (1961).

69. *Missouri v. Holland*, 252 U.S. 416, 432-33 (1920).

70. *Cook v. United States*, 288 U.S. 102, 120 (1933).

71. Foreign Sovereign Immunities Act, § 4(a), 28 U.S.C. § 1602 (1982) [hereinafter FSIA]; Vienna Convention on Diplomatic Relations, *opened for signature* Apr. 18, 1961, art. 31, 23 U.S.T. 3227, 3240-41, T.I.A.S. No. 7502, at 14-15, 500 U.N.T.S. 95, 112 (entered into force Dec. 13, 1972); see Hill, *A Policy Analysis of the American Law of Foreign Sovereign Immunity Act*, 50 *FORDHAM L. REV.* 155 (1981) (a well documented discussion of the major problems inherent in the law of sovereign immunity). For example, it is unclear whether the Panama Canal Commission, which operates under the Panama Canal Treaty between the United States and Panama, is governed by U.S. fair employment laws or the terms of the Panama Canal

Relations, a multilateral treaty to which the United States is a signatory, grants various immunities to foreign diplomats working in the United States. This treaty defines diplomatic immunity and specifies which officials of a foreign government are entitled to that privilege.⁷² Depending on their status, foreign government agents may or may not be subject to suit in the United States.⁷³ The Vienna Convention defines the instances in which foreign governments are immune from U.S. legal processes and consequently beyond the reach of U.S. fair employment enforcement proceedings;⁷⁴ public international organizations enjoy similar immunities.⁷⁵

Like the multilateral treaties, and perhaps more relevant, are Friendship, Commerce, and Navigation (hereinafter FCN) treaties. A bilateral FCN treaty is a commercial agreement between two countries where each signatory grants legal status to the other's firms, allowing them to conduct business in the host country on a comparable, "national treatment" basis with the host's domestic firms.⁷⁶

The issue of whether these treaties apply in contravention of U.S. fair employment law was addressed in *Sumitomo*

Treaty, Sept. 7, 1979, United States-Panama, T.I.A.S. No. 10,030 (entered into force Oct. 1, 1979). Implementation of the preferential hiring program provided in the Panama Canal Treaty may not violate U.S. employment laws since the treaty would supersede prior inconsistent statutes such as Title VII and the ADEA. The U.S. Supreme Court in *Espinoza v. Farah Mfg. Co.* recognized a distinction between discrimination based on national origin and on citizenship and held that Congress did not intend to include distinctions based upon citizenship under Title VII. 414 U.S. 86 (1973). *Espinoza* thus does not interfere with the Panama Canal Treaty's provision allowing Panama to choose Panamanian citizens over U.S. citizens to fill jobs vacated by U.S. citizens. In fact, a question remains whether the Panama Canal Treaty permits Panama to choose between U.S. citizens or other foreign nationals from third countries to replace U.S. citizens in certain jobs as an expression of Panamanian self-determination under the terms of the Treaty.

72. Vienna Convention on Diplomatic Relations, *supra* note 71.

73. *Id.*

74. *Id.*

75. See Preuss, *Diplomatic Privileges and Immunities of Agents Invested with Functions of an International Interest*, 25 *AM. J. INT'L L.* 694 (1931); see also *infra* notes 121-22 and accompanying text.

76. Walker, *Modern Treaties of Friendship, Commerce and Navigation*, 42 *MINN. L. REV.* 805, 811 (1958).

2435985202

Shop America, Inc. v. Avagliano,⁷⁷ where the U.S. Supreme Court considered whether a bilateral FCN treaty excused a U.S. subsidiary of a Japanese company from Title VII coverage. Respondents' class action suit against Sumitomo alleged that Sumitomo exclusively hired male Japanese citizens to fill its executive, managerial, and sales positions. The Court held that because Sumitomo was incorporated in the United States and so was not a Japanese company, it had no right under the applicable FCN treaty to hire executive personnel of its choice when the choice had a discriminatory basis.⁷⁸

In reaching its decision, the Court examined the FCN treaty and set forth the parameters for its interpretation. Writing for a unanimous Court, Chief Justice Burger found that the purpose of an FCN treaty "was not to give foreign corporations greater rights than domestic companies, but instead to assure them the right to conduct business on an equal basis without suffering discrimination based on their alienage."⁷⁹ The Court held that so long as the plain meaning of the treaty language does not yield a result inconsistent with the signatories' intent or expectations, "[t]he clear import of treaty language controls."⁸⁰ Not only did the Court find the language clear,⁸¹ but it cited to the U.S. State Department and the Japanese Ministry of Foreign Affairs for their identical interpretations of the treaty and of Sumitomo's status under it.⁸² The Court's role is "limited to giving effect to the intent of the treaty parties,"⁸³ and since the parties were in agreement, the Court did not address Sumitomo's contention that the FCN treaty grants "broad dis-

77. 457 U.S. 176 (1982).

78. *Id.* at 189. The treaty clause at issue provided that "[c]ompanies of either Party shall be permitted to engage, within the territories of the other Party, accountants and other technical experts, executive personnel, attorneys, agents and other specialists of their choice." Treaty of Friendship, Commerce, and Navigation, Apr. 2, 1953, United States-Japan, art. VIII(1), 4 U.S.T. 2063, T.I.A.S. No. 2863.

79. *Sumitomo*, 457 U.S. at 187-88.

80. *Id.* at 180.

81. *Id.* at 182.

82. *Id.* at 183-84; see also *Kolovrat v. Oregon*, 366 U.S. 187, 194 (1961) (the interpretation of the government department in charge of the treaty's negotiation and enforcement is given "great weight").

83. *Sumitomo*, 457 U.S. at 185.

cretion" for Japanese to employ its nationals in a manner contrary to Title VII proscriptions. The Court did, however, term this contention an issue "of widespread importance."⁸⁴

The *Sumitomo* holding has influenced subsequent proceedings considering the reach of an FCN treaty. In *Wickes v. Olympic Airways*,⁸⁵ a Michigan resident challenged a foreign corporation's employment practices, contending that his termination as a district sales manager violated Michigan's civil rights laws that prohibit discrimination on the basis of age and national origin. The defendant airlines argued that the language of an applicable Greek FCN treaty created a broad exception to U.S. labor and employment law and overrode the relevant Michigan provisions. The district court granted summary judgment for Olympic on the grounds that Wickes' discrimination suit was barred by the provisions of the FCN treaty, which contained the same "of their choice" language as the U.S.-Japanese treaty in *Sumitomo*. On appeal, the Sixth Circuit reversed.⁸⁶

The Sixth Circuit found that the FCN treaty did provide Greek companies doing business in the United States and U.S. companies in Greece some freedom to favor their own citizens for certain positions.⁸⁷ In an amicus brief requested by the court, the State Department recommended that the court reject Olympic's broad interpretation of the treaty:

Under Olympic's interpretation [the employer] would have an absolute right to hire white Americans over black Americans solely on the basis of race, American males over American females solely on the basis of sex, and Protestant Americans over Jewish Americans solely on the basis of religion. In short, Olympic's position, if adopted, would undermine fundamental state and federal policy without advancing even remotely the purposes underlying the Treaty. The drafters of the Treaty could not have intended this result.⁸⁸

84. *Id.* at 182 n.7.

85. 745 F.2d 363 (6th Cir. 1984).

86. *Id.* at 369-70.

87. *Id.* at 367.

88. Brief for the United States as Amicus Curiae at 6, *Wickes*, 745 F.2d 363.

The Sixth Circuit relied heavily on the *Sumitomo* decision to interpret the FCN treaty at issue and concluded that Olympic had "no license to discriminate against or among non-Greek citizens it hires"⁸⁹ for those positions not covered by the treaty. The court did state, however, that the language of the treaty afforded "Olympic a narrow privilege to discriminate" for positions covered by the treaty.⁹⁰

IV. PROCEDURAL AND SUBSTANTIVE ISSUES AT ADMINISTRATIVE AND JUDICIAL LEVELS

Consideration of a number of factors, including the status of the individual bringing a discrimination action, the status of the employer involved, and the pertinent international and foreign laws of the host country will determine whether U.S. employment laws can be applied to any particular case.

Analysis of an individual's status, in turn, involves several factors. A first consideration is whether the plaintiffs are U.S. citizens or aliens. For cases brought by applicants for employment, a court must determine the country in which they sought particular jobs. For cases in which individuals are already employed, the nature of their duties and the places where these duties are carried out are significant.

The status of the employer is a second key to determining extraterritorial application of a particular fair employment law. Is the corporation U.S. owned or controlled? Is it owned by a foreign government or a public international organization? Where does the corporation do business? Does it operate in the United States or its territories? The corporation's place of incorporation and the place where the alleged discriminatory decision occurred are additional relevant factors. For example, when the foreign employer's alleged discriminatory practice occurs in the United States involving a U.S. citizen or alien, the employer's doing business in the United States may be a sufficient basis upon which to hold it responsible for its employment practice. However, if the alleged discriminatory practice involving a U.S. citizen happens abroad, the foreign employer might

89. *Wicks*, 745 F.2d at 369.

90. *Id.* at 368-69.

need to be incorporated in the United States, in order to be held responsible for doing continued business, in order to be held responsible.

Finally, if a defendant raises conflicting foreign jurisdictional defense to the case, the foreign court must be examined. The rights of other countries (nationals) may be involved: application of the ADEA, or Title VII may obstruct or contradict international law by interfering with the sovereignty, institutions, social conditions, or commercial practices of another country.

A. Status of the Person: U.S. Citizens Employed Abroad

With the 1984 ADEA amendment, a U.S. citizen can now bring an ADEA antidiscrimination action against an employer for discriminatory practices occurring outside the United States.⁹¹ The EPA, on the other hand, remains mostly limited to the territorial United States.⁹² U.S. citizens working abroad can generally bring Title VII actions since these people do not fall within the narrow exemption of section 702.⁹³

Title VII's application to U.S. citizens abroad arose in *Fernandez v. Wynn Oil Co.*,⁹⁴ where a female U.S. citizen working abroad brought a Title VII action against a U.S. transnational employer, an oil company incorporated in the United States. The defendant employer argued that its decision not to promote the plaintiff resulted from her lack of qualifications, not from her sex; yet in the alternative the employer argued that sex is a bona fide occupational qualification (hereinafter BFOQ) for certain positions in countries where customers may refuse to do business with women.⁹⁵ Since the court disposed of the case on the plaintiff's failure to present a prima facie case, the court did not reach the question of whether Title VII applies extraterritorially. However, in reversing the lower court's finding that being male was a BFOQ,⁹⁶ the Ninth Circuit stated that "[t]hrough the United

91. See *supra* text accompanying notes 24-28.

92. See *supra* text accompanying notes 29-42.

93. See *supra* text accompanying notes 43-56.

94. 653 F.2d 1273 (9th Cir. 1981).

95. *Id.* at 1275.

96. *Id.* at 1276. The court noted that 42 U.S.C. § 2000e-2(e) considers sex to be a BFOQ only if it is "reasonably necessary to the normal opera-

States cannot impose standards of nondiscriminatory conduct on other nations through its legal system, the district court's rule would allow nations to dictate discrimination in this country. [N]o foreign nation can compel the non-enforcement of Title VII here."⁹⁷ The *Fernandez* court thus implied that no exceptions to Title VII requirements exist in the international sphere and that, had the plaintiff set forth a prima facie case, the court would have applied traditional Title VII principles.⁹⁸

B. *The Status of the Employer*

1. *ADEA*

The 1984 ADEA amendment provides protection to U.S. citizens employed by U.S. firms and their subsidiaries or by foreign employers controlled by a U.S. firm.⁹⁹ The 1984 amendment does not apply "where the employer is a foreign person not controlled by an American employer,"¹⁰⁰ where the employee works abroad. The amendment does, however, bring the practices of some foreign corporations within the scope of the ADEA.

The amendment lists four factors to consider when determining whether an employer meets the statutory "control" requirement:

- (A) interrelation of operations [between the employer and the other firm],
- (B) common management,
- (C) centralized control of labor relations, and
- (D) common ownership of financial control of the employer and the corporation.¹⁰¹

These four elements are essentially common law agency re-

tion of that particular business." *Id.* Thus, stereotypes of male and female roles cannot support sex as a BFOQ.

97. *Id.* at 1277. In striking down the lower court's finding that sex was a BFOQ in this circumstance, the court discussed the EEOC regulations allowing customer preference as a BFOQ only for the purpose of "genuineness or authenticity (e.g. a performer)." *Id.* (citing 29 C.F.R. § 1604.2(a)(2) (1972)).

98. *Id.* at 1276.

99. See 29 U.S.C. § 623(g)(3) (Supp. III 1985); *supra* text accompanying notes 24-28.

100. 29 U.S.C. § 623(g)(2).

101. *Id.* § 623(g)(3)(A)-(D).

quirements, as recognized by the courts in *Armbruster v. Quinn*¹⁰² and *Lavrov v. NCR Corp.*¹⁰³

The 1984 ADEA amendment defers to the authority of a host country's laws: non-compliance with the ADEA is not unlawful "where such practices involve an employee in a workplace in a foreign country, and compliance with . . . [the ADEA] . . . would cause such employer, or a corporation controlled by such employer, to violate the laws of the country in which such workplace is located."¹⁰⁴ This language suggests that when a host country formally objects on the basis of its own law to the enforcement of an antidiscrimination principle, the adjudicating body must dismiss the action against the transnational employer. Thus, the 1984 amendment indicates Congressional awareness of possibly conflicting laws and economic or domestic interests between the United States and other countries. But the ADEA amendment seems to apply by its terms to any foreign subsidiary of a U.S. company, regardless of the nature of its relationship with its parent company.

2. *EPA*

The EPA does not usually apply to a U.S. or foreign citizen employed abroad by either a U.S. or foreign employer.¹⁰⁵

3. *Title VII*

Title VII applies to foreign subsidiaries of U.S. companies, that is, to companies owned by a U.S. company though incorporated elsewhere. Several types of corporations might fall into this category and therefore fall within the reach of administrative or judicial scrutiny in the United States. Each presents its own question for litigants seeking relief. For instance, if the transnational employer is a U.S. company, then a plaintiff will need to know if the relevant statute in fact applies to a U.S. employer's workplace outside the United

102. 711 F.2d 1332, 1335-39 (6th Cir. 1983).

103. 591 F. Supp. 102, 105-07 (S.D. Ohio 1984); see also *Radio & Television Broadcast Technicians Local 1264 v. Broadcast Serv. of Mobile, Inc.*, 380 U.S. 255, 256 (1965) (per curiam).

104. 29 U.S.C. § 623(f)(1) (Supp. III 1985).

105. See *supra* text accompanying notes 29-42.

States. If the employer is a foreign subsidiary of a U.S. company, then even if the discriminatory act has occurred outside U.S. borders, a court must determine whether the foreign subsidiary is doing business in the United States.¹⁰⁶ Another relevant consideration is whether a subsidiary was created for the sole purpose of avoiding the provisions of Title VII. Whether a U.S. company's foreign subsidiary acts as the agent of the parent company may also be relevant, even though, as a general rule, a subsidiary of a parent company is treated as an autonomous legal entity.

Under some circumstances, a subsidiary may be exempt from Title VII coverage. The single-employer doctrine may apply to remove the employer from the reach of Title VII because the separate entity concept is used in international law for an entirely different purpose that it is usually used in national law.¹⁰⁷ Where a subsidiary of a U.S. company is incorporated abroad¹⁰⁸ for the sole purpose of avoiding U.S. fair employment laws or where the foreign subsidiary is an agent of a U.S. firm, the ADEA and Title VII apply to the overseas operations of the foreign subsidiary if the parent

106. *Lavrov*, 591 F. Supp. at 109; *Broadcast Service*, 380 U.S. at 256; see also EEOC Dec. No. 85-16, 2 Empl. Prac. Guide (CCH) ¶ 6857 (Sept. 16, 1985).

107. Thompson, *United States Jurisdiction over Foreign Subsidiaries: Corporate and International Law Aspects*, 15 LAW & POLY IN INT'L BUS. 319, 366-67 (1983).

108. Although place of incorporation is only one indication that the foreign subsidiary is doing business in the host country, this may be an important factor in deciding whether to assert jurisdiction. Thompson, for one, supports this conclusion:

[T]he place of incorporation should not be a determining factor by itself, [but] it is a factor that should be considered because it indicates specific interests of the host country that are not present when a separate subsidiary is involved. For example, if separate incorporation is required as a condition to enter a state or a specific business within it, that requirement may demonstrate the particular importance of that corporation or industry to the host state that is not present when a foreign person is simply permitted to make use of the incorporation statute of the host state to gain a generally available privilege such as limited liability. States are sometimes willing to give special development rights only to locally chartered companies that have a certain amount of local ownership.

Id. at 392.

corporation exercises sufficient control over the subsidiary. In such situations, the particular factual setting may show that a single-employer relationship exists and a court may be inclined to disregard the subsidiary and pierce the corporate veil.

Failure to show sufficient relationship between a U.S. parent company and its foreign subsidiary, however, could result in a finding that the parent is not responsible for the actions of its subsidiary, thereby leaving the employer beyond the reach of U.S. law and providing no remedy to the employee. In *Lavrov*, a Title VII case, the court relied on *Armbruster* to outline those considerations important to a determination of whether the business activities of a U.S. parent company and its subsidiary are indistinguishable; when the activities of the two entities become inseparable, either the joint employer or single-employer theory may be applicable.¹⁰⁹ The *Armbruster* court determined the most essential requirement in deciding whether to treat a parent and a subsidiary as a single entity: the extent to which the parent's control over the subsidiary surpasses the control typically exerted over a subsidiary by a separate corporate entity.¹¹⁰

The *Lavrov* court concluded that Title VII did not extend to acts of a foreign subsidiary of a U.S. company abroad, at least with regard to the employment of Americans abroad.¹¹¹ The court held that the subsidiary, which did no business in the United States, even though it was incorporated there and was owned by a U.S. corporation, did not

109. *Lavrov*, 591 F. Supp. at 107.

110. *Armbruster*, 711 F.2d at 1338; see *Milgo Elec. Corp. v. United Business Communications*, 623 F.2d 645, 659, 662 (10th Cir.), cert. denied, 449 U.S. 1066 (1980); see also *Chaiffetz v. Robertson Research Holding Ltd.*, 798 F.2d 731 (5th Cir. 1986) (citing *Trevino v. Celanese Corp.*, 701 F.2d 397, 404 (5th Cir. 1983) (listing factors determining whether distinct entities constitute an integrated enterprise)).

111. *Lavrov*, 591 F. Supp. at 110. The court relied on the Supreme Court's holding that, without strong proof of legislative intent, "federal laws regulating employee/employer relations do not apply to foreign employers." *Id.* at 110 (citing *Benz v. Compania Naviera Hidalgo*, 353 U.S. 138 (1957); *McCulloch v. Sociedad Nacional de Marineros de Honduras*, 372 U.S. 10 (1963)). Thus, the court determined that there was insufficient evidence in the statute or legislative history to find that Congress intended Title VII to apply to the employment practices of foreign corporations outside the territory of the United States. *Id.* at 111.

1585985202

have sufficient U.S. contacts sufficient to subject the company to U.S. law.¹¹²

C. Ownership of a Transnational Employer

1. Transnational Employers Owned by a Foreign Country

A transnational employer owned by a foreign country is not necessarily outside the administrative or judicial scrutiny of the United States. The EEOC has considered a foreign corporation to be covered by Title VII when it "manages the assets and operates the corporation for the benefit of that foreign government."¹¹³ Yet whether a wholly owned instrumentality of a foreign government is immune from the U.S. legal process is not always clear.¹¹⁴ Generally, foreign governments and their agents engaged in noncommercial activities are excluded from U.S. administrative or judicial process due to their diplomatic immunity.¹¹⁵ For example, if a foreign government funds a national cultural institute, which in turn has an overseas subsidiary located in the United States, and the subsidiary's primary purpose like that of the parent is the exchange of cultural and educational information with the United States, Title VII may apply to the subsidiary's practices.¹¹⁶ If the foreign country has delegated to the institute and its subsidiary the ability to act on the foreign country's behalf and both the parent and the subsidiary are fully funded by the foreign government, the employer may be subject to the fair employment laws of the United

112. *Id.*; see also 129 CONG. REC. S17,018 (daily ed. Nov. 18, 1983) (statement of Sen. Grassley as to the application of the single-employer analysis to ADEA cases).

113. EEOC Dec. No. 85-16, 2 Empl. Prac. Guide (CCH) ¶ 6857 (Sept. 16, 1985).

114. See generally EEOC Dec. No. 86-8, 2 Empl. Prac. Guide (CCH) ¶ 6866 (Apr. 25, 1986) ("employment practices in the United States are [not] exempt from [Title VII] because of a protocol [agreement] between the United States and a foreign country which owns [it]").

115. See FSIA, 28 U.S.C. §§ 1602-1611.

116. See *supra* notes 71-75 and accompanying text; see also EEOC Dec. No. 85-12, 2 Empl. Prac. Guide (CCH) ¶ 6853 (July 31, 1985) (a foreign government-owned hospital is covered by Title VII since section 701(a) defines it as a legal entity not exempt from the statute). If similar language appeared in the ADEA or the EPA, then, presumably, that language would make each of these statutes applicable to foreign-owned facilities as well.

States.¹¹⁷ The EEOC recently held that "[t]he burden is on the foreign state claiming immunity under the Foreign Sovereign Immunity Act (FSIA) to prove the non-applicability of the specified exemptions contained in [the FSIA]."¹¹⁸ Moreover, the EEOC decision stated that if the evidence offered is insufficient such that no decision can be rendered, then neither the FSIA nor the Vienna Convention exemption protects a transnational employer from the reach of Title VII even though the employing company is owned by a foreign government.¹¹⁹ A foreign government or its agent, however, could be excluded from U.S. domestic laws under international law.¹²⁰

2. Transnational Employers as Instrumentalities of International Organizations

Public international organizations located in the United States, such as the Inter-American Development Bank, the International Monetary Fund, and the World Bank, generally are not bound by the provisions of the ADEA, the EPA, or Title VII, due to their immunity under international law and U.S. domestic law.¹²¹ U.S. federal law usually exempts international organizations and their officials from the U.S. domestic legal process.¹²²

117. EEOC Dec. No. 85-12, ¶ 6853.

118. *Id.*

119. *Id.*; see also *State Bank of India v. NLRB*, 808 F.2d 526, 535 (7th Cir. 1986) (declining to determine the precise limits the FSIA places on NLRB jurisdiction because commercial operations of petitioner within the United States placed it outside the scope of FSIA jurisdictional limitations).

120. Article 3 of the Vienna Convention on Diplomatic Relations defines diplomatic immunity as applied to officials of a foreign government. Vienna Convention, *supra* note 71, art. 3. Article 3 also describes the nature of a diplomatic mission and its function.

121. See FSIA, 28 U.S.C. § 1602; Vienna Convention, *supra* note 71; see also *Preuss*, *supra* note 75.

122. See *Mendaro v. World Bank*, 717 F.2d 610, 614-17 (D.C. Cir. 1983); *Broadbent v. Organization of Am. States*, 628 F.2d 27, 35-36 (D.C. Cir. 1980); *International Organizations Immunities Act*, § 2, 22 U.S.C. § 288a; see also FSIA, 28 U.S.C. §§ 1602-1611; *Organization of American States*, Apr. 30, 1948, 2 U.S.T. No. 2394, T.I.A.S. No. 2361. The EEOC's current position on public international organizations operating within the territorial borders of the United States is that such organizations are generally immune from the legal processes of Title VII, the ADEA, and the EPA.

3. *Privately Owned Transnational Employers*

Although a privately owned transnational corporation is governed primarily by the laws of the country where it was created, its presence in another country generally allows the latter country to exercise some degree of authority. Thus, a transnational corporation doing business in the United States may subject itself to the jurisdiction and powers of the U.S. courts as if it were a U.S. corporation. Thus, a transnational employer may be bound by laws other than those of the country where it was created. U.S. law usually treats foreign companies in the same way as natural persons within the jurisdiction.¹²³ But considerations of foreign policy will minimize the simple application of the "minimum contacts" test. At least one court has said that "a purely *ad hoc* weighing of contacts basis . . . would inevitably lead to embarrassment in foreign affairs and be entirely unfeasible in actual practice."¹²⁴ A blanket application of the "minimum contacts" analysis of *International Shoe*,¹²⁵ without regard to considerations such as a direct connection between an alleged discriminatory act and the foreign or U.S. company's operations abroad could result in an intrusion into the affairs of foreign transnational employers or countries,¹²⁶ thereby dis-

with respect to their actions regarding employees. In its 1986 Policy Statement on International Organizations, the EEOC stated:

Public international organizations, unlike private corporations, enjoy the status, immunities, exemptions, and privileges to contract, acquire property, or institute legal proceedings in the United States and yet are immune from suit unless that immunity is specifically waived by the organization or by order of the President of the United States. They enjoy this immunity because their activities from which all nations collectively benefit are designed to resolve international concerns crossing national boundaries. For instance, while multinational corporations may be required to conform their employment practices to reflect an individual nation's rules, regulations, or laws for a particular reason, this is not always true of a public international organization. These organizations are generally left to handle their own personal matters while operating in the United States.

EEOC Notice No. 87-P-5 (CCH) (Dec. 15, 1986).

123. See *Bethlehem Motors Corp. v. Flynt*, 256 U.S. 421 (1921).

124. *McCulloch*, 372 U.S. at 19.

125. 326 U.S. 310 (1945).

126. EEOC Dec. No. 85-16, 2 Empl. Prac. Guide (CCH) ¶ 6857 (Sept. 16, 1985).

turbing international relations.¹²⁷

D. *Status of the Country: Treaties and Foreign Law*

One type of FCN treaty allows signatory nations to grant legal status to each others' corporations, enabling the corporations to conduct business on terms comparable to those of domestic firms.¹²⁸ Where, for example, the treaty is the same as that in *Sumitomo*,¹²⁹ under which the nationality of a corporation¹³⁰ is determined by its place of incorporation rather than by its controlling entity, the foreign-owned corporation is bound by Title VII and, presumably, the ADEA and the EPA. When a foreign corporation asserts an FCN treaty as a defense to coverage, the U.S. Supreme Court's decision in *Sumitomo* will generally control.

Following World War II, the United States entered into

127. See generally *Timberlane Lumber Co. v. Bank of Am.*, 549 F.2d 597 (9th Cir. 1976), *on remand to* 574 F. Supp. 1453 (N.D. Cal. 1983), *aff'd*, 749 F.2d 1378 (9th Cir. 1984), *cert. denied*, 472 U.S. 1032 (1985). In *Timberlane*, the U.S. Supreme Court had a golden opportunity to resolve the issue of what types of connections are necessary between the United States and another country to justify an assertion of the extraterritorial coverage of antitrust laws. The *Timberlane* case would have also shed light on how U.S. antidiscrimination laws such as the ADEA, the EPA, and Title VII apply extraterritorially.

128. See EEOC Dec. No. 86-2, 2 Empl. Prac. Guide (CCH) ¶ 6860 (Nov. 22, 1985); see also *supra* text accompanying note 76.

129. The Court expressed no view as to the interpretation of other FCN treaties although they may be similarly worded, noting that these treaties may have different negotiating histories. *Sumitomo*, 457 U.S. at 185 n.12.

130. A series of *ad hoc* solutions, each suited to a particular situation, may be appropriate in deciding the nationality of a corporation. Alternatively, corporate nationality may be decided by applying a single definition or a combination of factors creating a suitable test. The following six factors have been suggested:

(1) the jurisdiction of incorporation; (2) the principal place of doing business; (3) the nationality of the holders of voting stock; (4) the nationality of the suppliers of the funds invested, in particular equity funds; (5) the nationality of corporate management and the personnel operating the instrumentalities in question; and (6) the locus of "control" in a sense to be determined under *ad hoc* administrative standards.

Vagts, *The Corporate Alien: Definitional Questions in Federal Restraints on Foreign Enterprise*, 74 HARV. L. REV. 1489, 1526 (1961).

FCN treaties with several countries.¹³¹ These treaties gave foreign and U.S. corporations reciprocal trade rights while operating in each other's countries. Although many of these original treaties are no longer in force, the role of the State Department in this area continues to be substantial. The Department's interpretation carries considerable weight whenever a U.S. court is presented with a dispute involving an FCN treaty.¹³² But U.S. courts exercise the greatest degree of deference when dealing with cases that have significant international ramifications.¹³³

The *Sumitomo* decision, while raising important questions for U.S. courts' treatment of FCN treaties, did not address whether citizenship could constitute a BFOQ or "business necessity" defense under Title VII¹³⁴ for companies that give preferential treatment to their own citizens for certain jobs. Although the Court did not reach this issue, the "business necessity" defense rather than the BFOQ defense is perhaps more liberal in the transnational context. The BFOQ defense is only available as an extremely narrow exception to discriminatory employment practices.¹³⁵ The business necessity defense is a broader exemption from U.S. fair employment laws and is, therefore, better suited in instances where employers use foreign language, customs, and citizenship criteria in determining employee qualifications. Using these criteria as the basis for selecting individuals can be defended on the grounds that the preferences have "a manifest relationship to the employment in question."¹³⁶ An evaluation of the permissibility of preferential criteria should include consideration of whether the requirement itself was intended by Congress to be a legitimate preference or business necessity. An affirmative finding of either one would

131. See Walker, *Treaties for the Encouragement and Protection of Foreign Investment: Present U.S. Practice*, 5 AM. J. COMP. L. 229, 230 n.3 (1956).

132. See, e.g., *Spiess v. C. Itoh & Co. (Am.)*, 643 F.2d 353, 356-58 (5th Cir. 1981), *vacated on other grounds*, 457 U.S. 1128 (1982); *id.* at 369-72 (Reavely, J., dissenting).

133. Cardozo, *supra* note 61, at 461.

134. See *Sumitomo*, 457 U.S. at 180 n.4, 189 n.19.

135. See *Dothard v. Rawlinson*, 433 U.S. 321 (1977); *Diaz v. Pan Am. World Airways*, 442 F.2d 385 (5th Cir.), *cert. denied*, 404 U.S. 950 (1971).

136. *Griggs v. Duke Power Co.*, 401 U.S. 424, 432 (1971).

excuse a foreign corporation from demonstrating that a preference in question is job related.

Other questions were left unanswered by the *Sumitomo* decision concerning the relationship between FCNs and U.S. antidiscrimination laws. One question is whether the treaty at issue in *Sumitomo* and similar FCN treaties entitle a foreign company incorporated in another country to claim an exemption from the EPA, the ADEA, or Title VII, even when the company does business in the United States. A second question is whether the *Sumitomo* decision applies to branches or other forms of a foreign enterprise that are present, but not incorporated, in the United States.

A third question is whether an FCN treaty permits a foreign company to fill all of its top management positions or any one management level with "treaty-trader" supervisors, executives, and other specialists.¹³⁷ Unfettered use of treaty traders may result in discrimination against Americans on the basis of national origin by substantially reducing the number of jobs with foreign companies available to U.S. citizens. Determining who shall qualify for a treaty-trader visa may effectively determine the extent to which foreign companies are allowed to fill management and specialist positions with their own nationals. Non-immigrant aliens seeking to work for a foreign company operating in the United States under an FCN treaty generally must obtain admission to this country through the treaty-trader visa program. Under U.S. immigration laws, before a treaty-trader is issued a visa, the State Department must certify that the non-immigrant alien will be engaged by the employer in the capacity of a supervisor or executive, or if employed in a minor capacity, that the applicant has specific skills essential to the operation of the company.¹³⁸ Provisions of FCN treaties that specify what positions within foreign companies may be filled with individuals of their choice¹³⁹ further determine who may be covered or excluded under the particular treaty.

A fourth question not addressed by *Sumitomo* is the definition of who can qualify as a specialist. A broad definition

137. See *supra* text accompanying notes 87-90.

138. *Id.*

139. See, e.g., Treaty of Friendship, Commerce, and Navigation, *supra* note 78, art. VIII(1).

2025865354

could enable a foreign firm to hire a large number of employees who are of a particular national origin.

A final question going to potential discrimination against Americans is what is meant by the term "engage" in FCN treaty provisions providing that "[n]ationals and companies of either Party shall be permitted to engage, within the territories of the other Party [certain employees] of their choice."¹⁴⁰ Is the authority to "engage" limited to hiring decisions, or does it also extend to discharge or termination actions and terms and conditions of employment?¹⁴¹

V. INTERNATIONAL FRAMEWORK OF LAWS THAT ENCOURAGE TRANSNATIONAL EMPLOYERS TO PRACTICE NONDISCRIMINATION

That no person shall be deprived of the right to work on the basis of race, color, sex, religion, or national origin has received global recognition. All the member states of the United Nations have pledged to promote and encourage respect for human rights and for fundamental freedoms for all without distinction as to race, sex, language, or religion.¹⁴²

140. *Id.* In *MacNamara v. Korean Air Lines Co.*, No. 82-5085 (E.D. Pa. filed Feb. 10, 1985), a U.S. citizen working for a Korean company's branch office in the United States filed suit against his foreign employer alleging age, national origin, and race discrimination in violation of the ADEA and Title VII. The employer moved to dismiss the suit on the basis that the employee failed to state a claim on which relief could be granted. The Korean company's motion was based on its interpretation of Article VIII(1) of the Treaty of Friendship, Commerce, and Navigation, Nov. 28, 1956, United States-Korea, art. VIII(1), 8 U.S.T. 2217, 2223, T.I.A.S. No. 3947, at 4. Portions of this treaty provision permit corporations to "engage" persons "of their choice" in their overseas operations for certain positions. The *MacNamara* court concluded that the plaintiff was an "executive within the meaning of the FCN Treaty" and that "engage" entitles a transnational employer to terminate employees.

141. There may also arise a situation in which a foreign company seeks to have a national of a third country admitted into the United States for employment. The nonimmigrant would not generally be admitted as a treaty-trader, since FCN treaties do not apply to requests for admission for individuals whose nationality is different from the nationality of the foreign company. There may be another visa available which would permit the admission of such an employee. See 9 U.S. DEP'T OF STATE, FOREIGN AFFAIRS MANUAL pt. 2, § 41.40(a) (1975).

142. U.N. CHARTER art. 1, para. 3; *id.* arts. 55-56; Universal Declaration of Human Rights, G.A. Res. 217, U.N. Doc. A/810, at 71 (1948). The

The International Covenant on Economic, Social, and Cultural Rights¹⁴³ reiterates the principle of nondiscrimination in employment and demonstrates the international community's desire to address the need for uniform employment rights for all working individuals. Article 2(2) of the Covenant provides that:

The States Parties to the present Covenant undertake to guarantee that the rights enunciated in the present covenant will be exercised without discrimination of any kind as to race, colour, sex, language, religion . . . [or] national or social origin.¹⁴⁴

Furthermore, Article 6 recognizes "the right to work" as an economic freedom.¹⁴⁵ These provisions are best understood to mean that individuals have a right to employment without regard to race, color, creed, sex, religion, language, or national origin.

Although global awareness of the right to employment free from discrimination is a part of international jurisprudence, it remains unclear precisely what standards transnational employers must actively observe. In the United States, however, the fair employment laws follow the principle of nondiscrimination in employment endorsed by the United Nations,¹⁴⁶ and substantially the same interpretation of this principle should be expected in other member countries. The Organization for Economic Co-operation and Development (OECD) and the United Nations Commission on Trade

international body declared that discrimination is prohibited and all persons are entitled to equal pay for equal work.

143. *Adopted* Dec. 16, 1966, G.A. Res. 220, 21 U.N. GAOR Supp. (No. 16) at 49, U.N. Doc. A/6316 (1966) (entered into force Jan. 3, 1976).

144. *Id.* art. 2, para. 2.

145. *Id.* art. 6.

146. A dichotomy between U.S. policy and practice is demonstrated by the U.N. government-sanctioned program that brings child-care workers into the United States from abroad. At present this program offers working adults from Western Europe employment in the United States as child-care workers, *viz.*, "au pairs" or live-in help. In exchange, the child-care workers receive some type of unspecified education paid for by their host. See *USA Today*, June 10, 1986, at 6D, col. 2. Given the United States' commitment to equal employment opportunity, one might expect such a program to extend to all foreigners, regardless of their nationality. But U.S. immigration policy, contrary to nondiscriminatory principles, favors some foreigners over others on the basis of nationality.

and Development (UNCTAD) provide a framework for cooperation on trade-related issues of employment nondiscrimination. These two world organizations should take the lead in establishing concern for individual rights in the workplace and in demonstrating the global commitment to legally enforceable standards which must be observed by all nations. These organizations can demonstrate that the international community is capable of resolving both present and future employment and trade-related disputes.

VI. CONCLUSION

Although U.S. fair employment laws can serve to strengthen the U.S. economy, as they are designed to do,¹⁴⁷ these laws also raise foreign policy concerns for the United States since corporate control of a business is a crucial economic concern of all transnational companies. Domestic laws such as the ADEA, the EPA, and Title VII can directly affect who controls a corporate structure and can exert a strong influence on the identity of a business in the international arena. Depending on their application, these laws could dictate to the corporate entity whom it may hire, for what position, and where that person can work. Such employment decisions are best left to the transnational employer whenever practical. When the employer's decisions result in employment discrimination, however, either the host country or a neutral international body should step in. When the host country takes this role, it must make every effort to protect the employment rights of the nationals of the employer's home country with a view toward reducing trade barriers and toward minimizing intrusion into the operations of transnational employers. This may be achieved in part through cooperation with the established international forums, such as OECD, that have addressed the issue of transnational employment and have adopted guidelines on the employment rights of individuals working outside their home territories. These guidelines should become legally enforceable on all members of the world community.

As for the United States, the central issue is this: to what

147. See S. REP. NO. 872, 88th Cong., 2d Sess. at 10-11, 17-22, reprinted in 1964 U.S. CODE CONG. & ADMIN. NEWS 2355, 2365, 2371-76.

extent can it legitimately exercise the authority of its laws over other countries, foreign transnational employers, and foreign individuals? The U.S. judicial and administrative system must not allow the public policy of promoting fair employment to be frustrated by foreign or transnational employers. Conversely, the U.S. judicial and administrative processes cannot allow unfair trade barriers to obstruct the free flow of trade between countries in the international marketplace. When U.S. fair employment law conflicts with laws of other nations, an analysis regarding whether the doctrines of sovereignty or comity come into conflict with prevailing U.S. law and underlying policies should be made. The balance should be tipped in favor of the national policy, enhanced by a global awareness of the right to be free from employment discrimination in the domestic or international workplace. The scale should be weighted in favor of enforcement of U.S. fair employment law only after a balancing of the equities, including an examination of the domestic laws of both parties and the applicable international law.

2025865357

B. International

EXCERPTS FROM
"1992 - AN INTRODUCTORY GUIDE"
BY CLIFFORD CHANCE

2025865358

FOREWORD

There can be few businesses today that are not aware of "1992" – the year designated by the European Community for the completion of the "Single European Market".

1988 has seen the publication by the European Commission of the great majority of the principal components of the 1992 programme. We can now see virtually the full picture of the 279 piece jigsaw of proposals which will shape the structure of European business over the next decade.

There may be many however who have not examined in detail individual pieces of the jigsaw or begun to assess the opportunities and the threats which the 1992 programme will generate. That is the purpose of this publication. It has been written jointly by our EC lawyers in Brussels and London and lawyers who practice in the different areas covered.

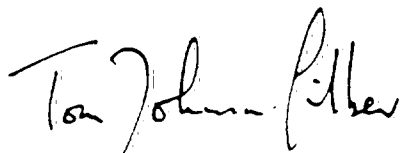
It is designed to provide an overview of:

- the 1992 programme in its economic context
- the new laws involved
- the impact on different business sectors

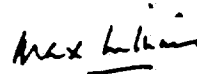
and describe the broad implications for EC companies and EFTA and Non-European companies.

Through our network of international offices, we are currently working with many organisations in a wide range of industry sectors in defining and assessing the impact of the 1992 programme on their businesses.

If you would like to explore further any of the issues raised in this guide or the more specific impact of the 1992 programme on your business operations in the European Community, the contact partners listed opposite will be pleased to assist.



Tom Johnson-Gilbert
Joint Senior Partner



Sir Max Williams
Joint Senior Partner

November 1988

Cover maps courtesy of the Commission of the European Communities.

CHAPTER 1

1. INTRODUCTION

The objective of the European Community is to create one market comprising 323 million people in which Community industry can compete on equal terms.

The internal market will be a self-contained market in which goods can circulate freely under conditions of undistorted competition and throughout which individuals and companies, regardless of where they are based within the Community, may carry on their business upon equal terms with their competitors. This is to be achieved by eliminating all artificial barriers to trade between the individual markets of the Member States. It should be as easy to trade between the UK and Italy as between Frankfurt and Hamburg; there should be no greater barriers between Italy and France than there are between Provence and Brittany.

When the European Community was established in 1957 many different economic barriers existed between the six original Member States which hindered the attainment of a single internal market. These barriers included customs duties, quotas on the import and export of each other's goods, immigration controls on the movement of citizens, monetary controls on the flow of capital between Member States and restrictive rules on the establishment of companies. The Treaty of Rome contained fundamental provisions aimed at eradicating such barriers.

A Community Customs Union was to be established. All customs duties and quantitative restrictions and all charges and other measures having an equivalent effect on imports and exports between Member States were to be removed. In addition, Member States would create a Common Customs Tariff whereby they would charge the same level of tariffs on all goods imported from non-Member States. Competition would be further encouraged by the implementation of comprehensive anti-trust rules. Controls on the movement of capital and payments were to be removed whilst freedom of movement was to be ensured for both individuals and companies, unhindered by national rules on such matters as immigration, qualifications or the right to set up in business.

The creation of an internal market was to be achieved by a gradual process. Transitional periods were laid down in the Treaty within which the market was to be established. Whilst the Treaty provided the general framework, secondary legislation was to be introduced by the EC Council to work out the details. Rapid progress was made in the early years. Customs duties between the original six were entirely removed by 1968. At the same time the Community succeeded in agreeing and creating its Common Customs Tariff. However, the recession of the 1970s, two oil crises and the difficulties caused by the accession of six new Member States have all reduced progress. The Council became dogged by political in-fighting and Member States began to introduce protectionist measures. By the 1980s most of the transitional periods had passed but it was clear that the attainment of the internal market was still a long way off.

2025865360

Faced with such slow progress the Member States decided to accelerate the establishment of the internal market. The Single European Act was signed in 1986 and came into force in 1987. Essentially, the Act provides for reforms in the law-making process of the Community designed to speed up decision making whilst laying down the framework for the introduction of certain fundamental Community policies. The most important of these is the Community's commitment to the creation of the single internal market by 1992:-

"an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured".

Thus, some thirty years into its existence, the European Community has designated 31st December 1992 as the deadline for the achievement of the internal market.

2025865361

CHAPTER 2

2. WHAT ARE THE BARRIERS TO THE ACHIEVEMENT OF THE SINGLE MARKET?

The programme for the completion of the internal market was set out in the Commission's White Paper of June 1985. This presents a detailed analysis of the barriers which need to be abolished and the positive action which needs to be taken before the single market can be achieved. It details some 300 measures, since reduced to 279, which must be implemented and the timetable within which this is to be accomplished.

The White Paper's analysis of the steps to be taken is set out under three convenient headings:

- removal of physical barriers;
- removal of technical barriers;
- removal of fiscal barriers.

2.1 REMOVAL OF PHYSICAL BARRIERS

2.1.1 *What physical barriers?*

The Commission sees it as essential to remove the customs and immigration barriers situated at national frontiers where goods and individuals are systematically stopped and checked. Politically, it is important for individuals to feel part of an integrated Community within which they can move freely from one country to another without scrutiny. From an economic standpoint, substantial savings can be made by limiting or removing cross-frontier controls on movements of goods.

Checks are currently made on the movement of goods for the following reasons:

- to enforce national trade quotas which may exist in some sectors;
- to operate the Community system of compensation in the agricultural sector;
- to collect VAT and excise duties;
- to carry out health controls;
- to carry out transport controls;
- to collect statistics.

Checks on individuals are carried out for the following reasons:

- immigration control of passports, visas and work permits to verify the identity and status of people crossing borders;
- security control against terrorists, drug carriers and wanted criminals;
- customs control to ensure that the tax authorities of the Member State of entry collect their due tax on goods carried by individuals.

2025865362

2.1.2 *What are the proposals for removal of these barriers?*

(a) *Free movement of goods*

The Commission has put forward a number of proposals aimed at simplifying controls and formalities. Significant progress was made in export and import procedures on 1st January 1988 with the introduction of the Single Administrative Document (SAD) and the removal of transit advice and guarantee requirements. The SAD replaced a multiplicity of forms, about 70 in all, with one document.

Other measures include

- the introduction of common border posts (banalisation) where all formalities are confined to a single stopping point between each Member State. Full adoption of 'banalisation' is designed to pave the way for the removal of all systematic controls at frontiers and their replacement with occasional spot checks;
- a reduction in the number, and the eventual elimination, of national trade quotas. The Commission indicated in the White Paper that if it were to prove impossible to remove all quotas by 1992, some system would have to be devised to ensure that controls took place inside Member States and not at frontiers;
- the abolition of road transport quotas.

(b) *Free movement of individuals*

The Commission has put forward a number of proposals aimed at making checks more flexible pending the introduction of safeguards against terrorism and drug trafficking. As a second stage the Commission will make proposals to coordinate national rules on the control of drugs, the status of third country nationals, the right of asylum and status of refugees, visa policies, and extradition.

So far there has been virtually no progress on proposals put forward by the Commission. The Council has watered down the proposals and has failed to adopt even the revised measures. The only significant progress has been the setting up of a committee of senior officials from the Member States to promote and enhance cooperation between national police and judicial authorities and an ad hoc working party on immigration.

2.2 REMOVAL OF TECHNICAL BARRIERS

2.2.1 *What technical barriers?*

The targets are barriers which exist within Member States as a result of law, norms or practices which inhibit or prevent intra-Community trade in goods and services or the freedom of business to set up in other Member States. The barriers are many and various. Examples include:

Goods

- the need to meet different technical regulations or standards in different Member States;
- the duplication of testing and certification procedures in different Member States;

- the reluctance of the public authorities in certain Member States to open public procurement to nationals of other Member States.

Professions

- the restrictions on the exercise by professional people, such as lawyers and architects, of their skills in other Member States through non-recognition of their qualifications.

Services

- barriers created by the need to satisfy differing rules in each Member State, eg. in the banking and insurance sectors, and by the inability to provide services in such sectors across frontiers without setting up a branch or subsidiary in other Member States.

Capital movements

- barriers to the movement of capital between Member States, such as exchange controls.

Other

- other barriers existing within and between Member States relating to company law, intellectual property law and various forms of taxation, in particular taxation of companies and securities.

2.2.2 *What are the proposals for removal of these barriers?*

(a) *Elimination of technical barriers in relation to goods*

The Commission has adopted two methods to remove technical barriers; the **Cassis de Dijon** or “**mutual recognition**” approach and the **harmonisation** approach.

In **Cassis de Dijon** the European Court of Justice ruled that where a product is lawfully manufactured and marketed in one Member State, it should be able to be sold without restriction throughout the Community. In other words, if a product meets the legislative requirements in one Member State it is presumed to be of such a standard that it can be resold in all other Member States even if it does not precisely meet the requirements of the other states. This important judgment established the principle of **mutual recognition** of standards. The import and sale of a product from another Member State can only be refused if, in the particular circumstances of the case, it is necessary to satisfy a limited range of public interests, eg. health, safety and consumer and environmental protection.

In **Cassis de Dijon**, cassis (a liqueur) was marketed in France. German law required such liqueurs to contain a specified minimum amount of alcohol, which was higher than that contained in cassis. The European Court of Justice held that cassis could not be banned from sale in Germany because it did not contain the quantity of alcohol required by German authorities. A minimum alcohol requirement was not a **necessary** provision for the protection of public health.

The mutual recognition principle may not, however, always be sufficient. It does not deal with all cases where differing national regulations address similar public interest issues such as the protection of consumers in different ways, or where Member States adopt incompatible technical standards (as in the case of television or telecommunications). In such cases Community rules are needed to replace the varying legislative provisions of the Member States. This process, known as **harmonisation**, has been extensively used and relied upon by the Community for the past twenty-five years. The difficulty has been that the adoption of each harmonisation measure has normally required unanimity in the Council of Ministers. This has often either been impossible to achieve or taken up to fifteen years to agree.

Accordingly, the Commission has decided to reduce harmonising legislation to a minimum, ie. to harmonise only where this is essential in the interests of health, safety and consumer and environmental protection. The Single European Act ensures speedier passage of such legislation by replacing the requirement for unanimity by majority vote in most cases.

In areas where harmonisation is not absolutely necessary, the mutual recognition principle applies. Goods lawfully produced or marketed in any Member State can be sold in all other Member States.

As regards industrial standards, the Commission proposes to harmonise essential requirements and then leave it to European Standards Offices (CEN/CENELEC) to set up specific European standards. Conformity with the new European standards will entitle a product to free movement throughout the Community.

The Commission has taken steps to prevent the creation of new obstacles. A 1983 Directive obliges Member States to notify the Commission in advance of drafts of national regulations laying down technical specifications.

(b) *Elimination of technical barriers in relation to services*

The Commission recognises that the provision of services constitutes a key sector which has taken second place in Community legislative policy until now. Services represented 58.5% of the value added to the Community economy in 1985, compared with 26% for manufactured goods. The White Paper on the internal market treats goods and services equally.

Certain service sectors, such as banking, insurance and telecommunications, are heavily regulated and subject to differing rules in the various Member States. In most cases companies must meet the rules of the country in which they wish to set up business or provide services, ie. the rules of the host country. For example, a bank with its head office in one Member State wishing to provide financial services in the other Member States may have to operate under twelve different sets of rules and may be subject to twelve supervisory authorities.

2025865365

The Commission's approach to the constraints upon competition caused by such restrictions is to rely on **home country** rules and supervision. The rules applying in the state where the bank was originally based (the **home country**) would govern most of its activities in other Member States in which it provides services. **Host country** rules and control should be restricted to the minimum so as to avoid barriers. This principle will, subject to some variations, be applied to a number of sectors such as banking and insurance.

(c) *Elimination of barriers in relation to free movement of individuals*

Some barriers arise from the non-recognition of personal/professional qualifications; this may prevent or discourage individuals from working in other Member States. Action taken by the Commission in this field includes proposals on the mutual recognition of academic diplomas and on vocational training. Progress has been made in the health sector where doctors, nurses, dentists, and midwives, have all had their basic training harmonised and have thus obtained the right of practice in all Member States. There has also been progress in the mining, electricity, gas, oil and water industries.

The process of adoption of these directives has in the past been very lengthy. It took over fifteen years for architects and pharmacists. The Commission now intends to provide for harmonisation in a number of sectors of minimum requirements for qualification, experience and supervised training and, subject to that, the principle of mutual recognition will apply.

The Council reached a common position in June 1988 on the Directive on the mutual recognition of diplomas.

(d) *Opening up of public procurement*

The public procurement and supply contracts of the Member States represent a significant proportion of the Community GDP, yet only a fraction of such contracts have been awarded to companies from other Member States. The public sectors in Member States have consistently favoured national suppliers for strategic reasons (eg. defence), to support high technology, to maintain dual national suppliers and national competition, to maintain employment or protect important private sector companies. The most important industries benefiting from this protection are building and construction, transport equipment other than motor vehicles, electrical goods, capital equipment and telecommunications. These practices have continued notwithstanding longstanding Community directives.

The Commission has made a number of specific proposals:

- to tighten up controls on the procedures for tendering and award of public supply and works contracts (the public supply Directive was adopted by the Council in March 1988);
- to extend public procurement to four important areas hitherto excluded - transport, production and distribution of energy, water and telecommunications;

- to increase transparency of the public procurement procedures;
- to establish effective means of monitoring and enforcing the operation of the proposed Directives.

2.3. REMOVAL OF FISCAL BARRIERS

2.3.1 *What fiscal barriers?*

The targets are barriers created by the existence in the Member States of different types and rates of indirect tax. Problems arise particularly from Value Added Tax (VAT) and excise duties. At the moment, indirect taxes are collected by the country where the goods are finally consumed. The exporter exports goods tax free; an importer pays VAT and excise duties in the country of importation. VAT rates vary from 0% to 38%. Excise duties range from zero to 10.50 ECUs per bottle on alcohol. As long as indirect taxes and rates differ substantially between Member States, frontier controls will be necessary to ensure the due collection of taxes. The Commission takes the view that varying rates of indirect taxation have further negative effects: they create artificial price differences between countries to the detriment of consumers and represent an obstacle to free movement of goods and limit competition.

2.3.2 *What are the proposals for removing these barriers?*

The Commission concluded that a uniform system of indirect taxes was not a prerequisite to abolishing fiscal control at frontiers and avoiding trade distortion; nevertheless partial harmonisation of indirect taxes was regarded as essential. In the USA differences in taxes and tax rates of up to 5% exist between States without significant adverse effects. Thus, the Commission takes the view that it is only necessary to "**approximate**" indirect taxes to ensure that differences are sufficiently small to avoid distortion of trade. The Commission favours a system allowing a margin of plus or minus 2.5%/3% either side of each target rate of tax.

Such approximation of indirect taxation will have a considerable impact in many Member States with significant economic, social and political consequences. For example, France would have to abandon its higher rate of VAT of 33%, the UK would have to abandon its zero rate on certain products (such as books and food) and Denmark would suffer a fall of 9.5% in its total tax revenues. The Commission's view remains that approximation is a "manageable budgetary problem for Member States".

The Commission has made a number of specific proposals:

(a) *Proposals relating to VAT*

- the system for collecting VAT on sales and purchase across frontiers should be the same as that for the collection of VAT on sales within Member States. VAT would be charged and collected by the supplier. VAT incurred by the recipient (other than the final consumer) would be deductible irrespective of the Member State in which it had been charged;
- a Clearing House system would be set up which would ensure that tax collected in an exporting country and deducted or claimed as a tax credit in the country of import would be credited to the latter;

2025865367

- approximation of rates: The Commission has proposed two bands, one between 14% and 20% which would cover most goods and services, and a lower rate of between 4% and 9% for necessary items such as food, energy for heating and lighting, water, pharmaceuticals, books and journals and passenger transport. There would also be a standstill provision to ensure that, pending adoption of these measures, Member States will not depart further from the proposed Community objectives.

These proposals (which must be adopted by unanimous Council decision) are strongly contested by certain Member States including the UK.

(b) *Proposals relating to excise duties*

The products covered are similar throughout the Community, namely cigarettes and other tobacco products, alcohol, and mineral oils, eg. petrol and diesel fuel. There are some exceptions, notably wine, on which no duty is levied in Italy or Greece. Excise duties on beer, wine and spirits are highest in Denmark, Ireland and the UK. Since these duties represent a high proportion of the retail price, substantial discrepancies in excise duties create substantial price differences between Member States.

Specific proposals are as follows:

- harmonisation of rates of tax on cigarettes, other tobacco products, alcohol and mineral oils;
- further proposals for less significant goods on which excise duty is levied, and the interlinking of Community bonded warehouses. This would allow excisable goods to circulate freely in the internal market without payment of duty until they are finally consumed;
- abolition of duty free concessions.

Important progress has been made both by the Economic and Social Committee and by the Parliament. The Council has initiated discussions but no agreement has been reached.

2025865368

CHAPTER 3

3. WHY IS IT NECESSARY TO COMPLETE THE INTERNAL MARKET?

There are three principal reasons for striving to complete the internal market first envisaged some thirty years ago. The first is political and the other two are economic.

3.1 POLITICAL REASON

By their adhesion to the Treaty of Rome the six original members and the six new entrants committed their countries to the achievement of an internal market in which it was intended that enterprises could operate freely in competitive conditions and upon level terms. The failure of what is potentially the largest trading bloc in the world to achieve that objective and, indeed, the growth in the number of national protectionist measures inhibiting intra-Community trade in the 1970s and the 1980s, raised fundamental questions as to the value of the Common Market. In 1984 the Member States found the renewed political will to achieve the original objective of the Treaty of Rome by 31st December 1992.

It is doubtful whether that political will would have existed but for the perception of the economic benefits which could be realised if that objective were to be attained.

3.2 ECONOMIC REASONS

By whatever criteria – rates of industrial growth, share of external trade, investment or productivity – Community industry was lagging behind that of Japan and the USA. This was most marked in the high technology sector – data processing, office automation, precision instruments, electrical goods and electronics. For example, the Community's share of external trade in manufactured goods fell by 1.4% between 1979 and 1985 as against increases of 0.7% for the USA and 5.4% for Japan, whilst in the information technology and office automation sectors the Community's share fell by 2.2% whilst that of the USA and Japan increased by 3.3% and 5.5% respectively. Investment in the Community in the period 1981 – 1987 increased by 4% compared with 30% in the USA and 31% in Japan. The highest Community productivity rate in electrical and electronic goods was 47% of that in the USA whilst that of Japan was almost two and half times the US rate.

The reasons for that state of affairs included the relatively smaller size of Community companies, the existence of twelve fragmented markets and industry's consequent inability to achieve the necessary economies of scale in research and development and production; there was a consequent unwillingness to invest.

Yet potentially the EC is the largest market, with, in 1987, a population of 323 million compared with the USA at 244 million and Japan at 122 million. It had a GDP of 3,669 billion ECUs compared with 3,869 billion ECUs for the USA and 2,058 billion ECUs for Japan.

2025865369

The attainment of the single market will enable Community industry to seek to realise the full potential of this market. The potential arises in two ways. First, reduction of costs. Secondly, the competitive dynamics which will occur with the removal of the physical, fiscal and technical barriers. The economic studies of the "Cost of Non-Europe" commissioned by the Community under the supervision of Paolo Cecchini comprise some sixteen volumes of detailed economic analysis of the substantial costs of failure to attain a genuine Common Market and the corresponding gains which stand to be realised.

3.2.1 *Reduction of costs*

The prerequisite for the creation of the internal market is the removal of all physical, technical and fiscal barriers. The relative importance of individual barriers varies by country, by industry and by size of firm. A survey of Community industrialists found that physical barriers (customs and frontier delays) and technical barriers (standards and regulations), were the most significant both by country and by size of firm. In Italy and Portugal and in the office and data equipment and in the transport equipment (other than motor vehicles) sectors public procurement was one of the most significant barriers. Capital market restrictions were a significant barrier in the office and data equipment sector as were differences in VAT rates in the motor vehicle and leather and leather goods sectors.

Physical barriers

- of greatest importance in Portugal, Greece, Belgium, Spain and Italy;
- of greatest importance in man-made fibres, mineral oil refining, leather and leather goods, textiles and rubber products;
- estimated cost of these barriers ranges from 7.9 – 8.3 billion ECUs including the internal cost to business, the cost of using outside services, such as custom clearing agents, and transport delays;
- these costs represent approximately 1.7% of total intra-Community trade or nearly 2% of average consignment value;
- are of greatest importance to smaller firms;
- estimated costs of business opportunities lost range from 1% – 3% of intra-Community trade;

Technical barriers

- of greatest importance to the motor vehicle, electrical engineering, mechanical engineering, pharmaceutical and non-metallic mineral products sectors according to the Community industrialists survey;
- of greatest impact upon the electrical engineering, mechanical engineering, pharmaceutical, food and tobacco and precision and medical equipment sectors according to the Commission's experts;
- it is impossible to evaluate the aggregate costs on a global basis but the calculations for the telecommunications, vehicle manufacturing, food, construction products, textiles, clothing and pharmaceutical sectors which represent 43% of the Community's industrial output, show gains from removal of technical barriers of the order of 3 to 4 billion ECUs.

Public procurement

- this represented between 240 and 340 billion ECUs in 1986 or between 6.8 and 9.8% of GDP of the Community;
- only 2% of public procurement contracts have been awarded to firms in other Member States;
- the reduction in prices which would follow from open public procurement is estimated on 1984 data to be approximately 4.4 billion ECUs.

Fiscal barriers

- impossible to separate from physical barriers as one of the main reasons for frontier control is the present rates and arrangements for collection of VAT and excise duties.

Total

- the Commission estimates that the potential gains from the removal of these barriers range from 89 to 110 billion ECUs.

3.2.2 Competition effects

The anticipated cost savings resulting from the removal of physical, technical and fiscal barriers are perceived by the Commission to be of less importance compared with the triggering effect which their removal is expected to achieve. The twin effect of reduction in costs and thereby prices and the ability to treat the Community as a single market is expected to create a new competitive environment as Community industry adapts its strategy to take full advantage of the opportunities thereby created.

The trigger of price reductions and ready access to markets will increase competition and enhance demand, thereby further intensifying competition. Industry is expected to take advantage of economies of scale arising from the creation of a Community-wide market and of the ability to reduce the range of products required to meet demand in this market. Economies of scale in production, research and development, distribution and advertising are perceived in total to be significant, with the successful firms attaining the requisite minimum efficient size of operation.

This new competitive environment is expected to force industry to strive for greater efficiency by adopting the best and leanest methods of management and organisation. Moreover, industry is expected to focus on key product areas and dispose of peripheral operations. In industries where either significant overcapacity exists or where the minimum critical mass for operating in the market is high, further acquisitions and restructuring are likely to occur. The ability to amortise research and development costs over significantly higher sales, product specialisation and the greater perceived rewards for innovation will act as a spur to enhance research and development both by individual firms and through cooperative arrangements which will in turn intensify competition.

The Commission estimates that the potential gains from these market integration effects are between 84 and 147 billion ECUs.

3.2.3 Macroeconomic effects

The perceived macroeconomic effects in the medium to long term depend to a significant extent on whether or not the Member States and the Community adopt appropriate economic policies in the areas of public finance, external trade and inflation designed to maximise the potential benefits. The table below shows the potential gains which may be realised both without the adoption of such policies and with their adoption:-

Gross domestic product	Increase ranging from 4.5% to 7%
Consumer prices	Reduction ranging from 6% to 4.5%
Employment	Increase ranging from 1.75 to 5 million employed
Public sector balance	Improvement ranging from 2.25% to 0.5% as a percentage of GDP
External trade balance	Ranges from an improvement of 1% of GDP to a deterioration of .25%

3.3 SUMMARY

The Cecchini Report has publicised the potential "Costs of Non-Europe" as 200 billion ECUs. Its actual forecast ranges from 173 billion ECUs to 257 billion ECUs with 215 billion ECUs as the average.

Slightly under 50% of the gains derive from the reduction in costs. The principal contributor to the gains is the realisation of the potential arising from Community industry adapting to the new competitive environment in a positive, competitive and successful manner.

These gains will be gains which stand to be realised in a five to ten year period.

Whether or not they will be achieved and who will be the primary beneficiaries remains to be seen.

Although much of the research is theoretical and realisation of the potential is dependent upon successful competitive strategies being adopted by Community industry, the "Costs of Non-Europe" and, consequently, the gains to be realised by achieving a genuine internal market within Europe are substantial. These costs and gains are not evenly spread over all sectors of Community industry or indeed across the Member States. What is certain is that there will be enhanced competition and pace of change as more and more of Community industry and EFTA and Non-European companies hasten to take advantage of the changing face of Europe.

2025865372

CHAPTER 4

4. HOW THE INTERNAL MARKET IS TO BE ACHIEVED

4.1 THE INSTITUTIONAL AND LEGAL FRAMEWORK

This Chapter describes briefly the role of the Community institutions in the 1992 programme. It sets out the decision making and legal framework. It will be of interest to those who may seek to influence the content of proposals within the programme. The position is described more fully in the Annex.

4.1.1 *The institutions*

The four Community institutions primarily involved in the 1992 programme are the Commission, the Council, the Parliament and the European Court of Justice. The Commission proposes, the Parliament advises and the Council decides. These three institutions are subject to the supervision of the Court of Justice.

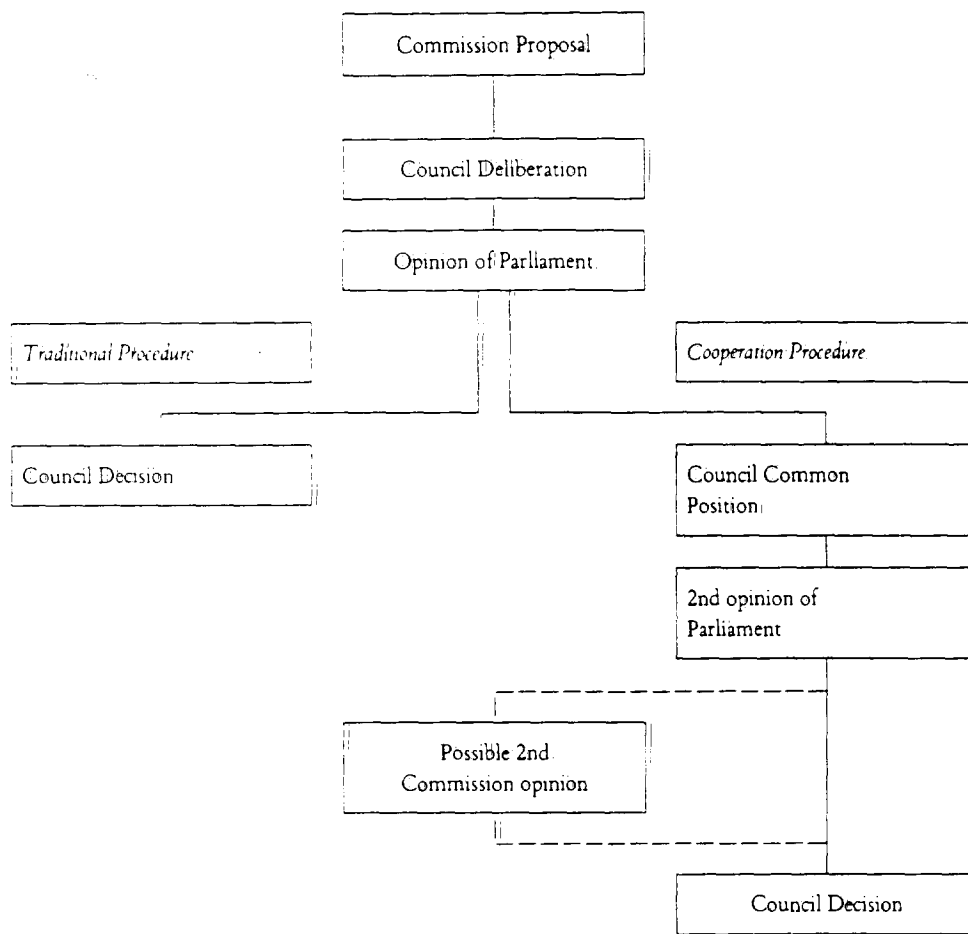
4.1.2 *The EC law-making process*

The first stage in the Community's legislative process is the drafting of a proposal by the Commission. The Commission has so far sent to the Council over 200 of the proposed directives listed in the White Paper. Approximately 70 more directives are at the drafting stage.

The Commission's proposal is forwarded to the Council. The Council is the primary law-making body in the Community. The Council will deliberate on the Commission's proposal and is empowered to reject, amend or approve, as it so wishes. Where the Treaty provides for consultation with the Parliament, however, the Council must first obtain the Parliament's opinion on the proposed measure before it makes its final decision. Moreover, the Single European Act has introduced what is known as the "**cooperation procedure**" in respect of certain measures. Whenever the cooperation procedure applies, the Council may not adopt a final decision upon receipt of Parliament's opinion. Rather, it must adopt what is known as its **common position**. That common position is then referred back to the Parliament for a second reading. The Parliament may decide to approve, reject or amend the Council's common position. It will then refer its second opinion to the Council. Should the Parliament propose amendments to the Council's common position, then the Commission must also put forward its views on the common position and on the Parliament's proposed amendments. Only upon receipt of the Parliament's second opinion may the Council finally make its decision.

2025865373

The various stages involved in the Community's law-making process can be illustrated diagrammatically:



There are important rules concerning the various majorities required at the different stages in the law-making process and the relevant time limits within which decisions and opinions must be given. These are outlined in the Annex.

The European Court of Justice (ECJ) plays an important role in the Community's legislative process. The ECJ supervises the actions of the Commission, Council and Parliament. Should any of these institutions act outside their powers, any resulting legislation may be annulled on appeal to the ECJ. Further, the ECJ plays an important role in interpreting and developing legislation adopted by other Community institutions and in ensuring that they are properly implemented by the Member States.

2025865374

4.1.3 *The nature of Community law*

The primary sources of Community law are the provisions of the Treaty of Rome. These rules, however, are further expanded by secondary legislation. Such legislation takes the form of regulations, directives, decisions, recommendations and opinions. With the exception of recommendations and opinions, secondary legislation binds Member States. The bulk of the legislation required for the completion of the internal market takes the form of directives. Member States are given a time limit within which to make the necessary changes to their own laws to implement the directives. Failure to implement within a time limit may result in defaulting Member States being brought before the European Court of Justice for a declaration that they are in breach of their Treaty obligations. Action will normally be brought by the Commission but may also be initiated by another Member State.

4.2 THE TIMETABLE FOR 1992

4.2.1 *1992 – What the date really means*

It should be stressed that “1992” means 31st December 1992. Furthermore, 1992 should not be seen as a fixed date by which the internal market will or will not be achieved depending upon whether the Community institutions and the Member States are successful in their objectives. Rather, it is a dynamic process which has already started and will continue beyond 1992. A number of measures have already been adopted and a larger number remain to be agreed.

4.2.2 *Possible delays and deadlocks in the decision making process*

None of the Community institutions is under formal time constraints in the early stages of the decision making process. The dates set out in the White Paper are targets. The Commission may make a proposal when it feels fit, Parliament is under no obligation to give its opinion by a certain time, nor is the Council under any such obligation in respect of its common position. The Parliament may deliberately postpone the delivery of its opinion as a delaying tactic to force the Commission to make concessions. With the increased role given to the Parliament the decision making process has become even longer and more cumbersome. At least one proposal has already lapsed altogether during the process of adoption. Against that, there are now many measures where the Council may ultimately make its decision by a qualified majority rather than by unanimous vote.

4.2.3 *Further possible obstacles to the attainment of the programme by 1992*

Most measures adopted under the White Paper are directives. This means that they must still be incorporated into the law of each Member State before they come into force. In many cases, therefore, even if a directive is adopted before the end of 1992, it will not come into force for some months or years after that date. Some Member States, and particularly those who have joined more recently, may be granted extra time within which to comply with certain measures.

Member States may fail to implement directives within the given time limits. Alternatively, they may keep to the schedule but may fail to interpret a directive correctly, perhaps by adopting a narrow construction contrary to the spirit, and sometimes to the letter, of the directive. In these cases it may be necessary for the Commission to bring Member States before the ECJ. Such cases, however, will take between one and two years before the Court finally gives judgment. Failure to implement Community legislation may thus considerably delay the achievement of the internal market.

4.3.4 *Progress to date*

The Commission issues progress reports every year. The third progress report was issued in March 1988 and a fourth in November 1988 for the meeting of the Council at Rhodes in December. Following withdrawals of some proposals and introduction of new ones the Commission's current programme consists of 279 proposals. Of these, 208 have been presented by the Commission to the Council and 94 have been adopted by the Council, including 6 which have been partially adopted. By the end of 1988 the Commission expects to have tabled 90% of the proposals.

The implementation of the programme is behind schedule. However, the speed at which decisions have been adopted increased considerably in the course of 1988.

2025865376



Buy it while you can: British day-trippers stock up during a cross-Channel shopping spree in the French city of Calais

Who's Afraid of 1992?

Europe's economic revolution will produce losers as well as winners

BY SCOTT SULLIVAN

Andre Ferré worries full time about the year 1992. As the owner of a small but prosperous horticultural firm in Brittany, he foresees that Spanish nurseries will flood the French market four years from now with good, and inexpensive, stocks of fruit trees. "If our government doesn't do something to help," he says, "our profession could be wiped out." As mayor of Asserac, a village of 1,132 inhabitants on Brittany's rugged south coast, Ferré also fears that his village may miss out on the boom in the European tourist trade that should come after 1992. "If Asserac has clean beaches, if we can build tennis courts and provide horseback riding for our visitors," he says, "we will thrive. If not, we will remain a backwater forever."

To Ferré and countless other Europeans, "1992" means nothing less than the start of a new world. Just one year ago, the European Community's plan to initiate a "single market" by Dec. 31, 1992,

remained a vague and not-quite-credible notion. Within the last few months, however, "1992" has caught the popular imagination. It has accelerated hundreds of European mergers and acquisitions. It has spawned seminars and discussion groups. It dominates dinner-party debates between "Euro-fanatics" eager for a stronger, more united continent and oppo-

nents wary of ceding economic power to the "Eurocracy." Millions of Europeans and all the Community's trading partners now realize that the single market will revolutionize the European scene—and it will produce losers as well as winners.

Doubts and concerns about 1992 are now bursting into the open. In a speech in Belgium late last month Britain's Prime

Minister Margaret Thatcher attacked the Community's executive commission for seeking a massive transfer of sovereignty from national capitals to Brussels, where the European Community maintains its headquarters. French Prime Minister Michel Rocard said that harmonizing European consumer taxes, which the Commission claims is essential for a single market, would "pauperize the [French] state." Karl Otto Pöhl, president of West Germany's Bundesbank, came out against the creation of a European Central Bank.



Ready for a grand debate: Thatcher and Mitterrand

NEWSWEEK/OCTOBER 31, 1988

2025865377

another pet Commission project. His reason: a formal Eurobank would erode the near-imperial authority that the Deutsche mark and the Bundesbank now exercise over European monetary affairs. American trade officials, who worry that Europe after 1992 may become more protectionist than ever, started referring to the coming internal market as "the infernal market."

Strikes and protests: Public officials are not the only ones who object to the grand plan of 1992. West German truck drivers intend to stage strikes to protest the deregulation of their heavily protected industry—and the probable loss of some 10,000 jobs. European employers' groups are fighting plans to write a new "European company law" that would give employees a voice in major corporate decisions. Trade union leaders are lobbying against what they describe as the emergence of a "businessman's Europe," which they contend would do nothing to advance workers' rights. And the list goes on. Danish ecologists fear that their country's strict environmental legislation will be weakened to conform with a Europe-wide standard. British animal lovers dread the thought that once frontier barriers are down rabies and hoof-and-mouth disease may spread to the United Kingdom.

Some of the current criticism is trivial. Much of it is contradictory. And it has been countered by solid public support and enthusiasm for a new "Europe without frontiers." Every political leader of the 12 European Community nations* is committed by treaty to the 1992 project. Polls of businessmen from each of the EC countries show that the majority favor the single market. In France, 76 percent of the presidents of small- and medium-size companies are optimistic about 1992, even though they are more vulnerable to outside competition than are larger companies. "Europhoria" is still the dominant mood in the Community. But the outright hostility that some major players are showing toward parts of the package could make it impossible to achieve a single market by the deadline.

Crucial questions: Of all the critics, Thatcher is the most influential. Even though European leaders agreed nearly three years ago that they would settle most future issues by majority voting, unanimity is still required on tax issues and other crucial questions. That means that a single leader can still exercise a veto on some issues, and Thatcher has made it clear she is prepared to exercise that right. Thatcher applauds the elements of the 1992 plan that will deregulate industry and services. But she rejects those elements that she believes are

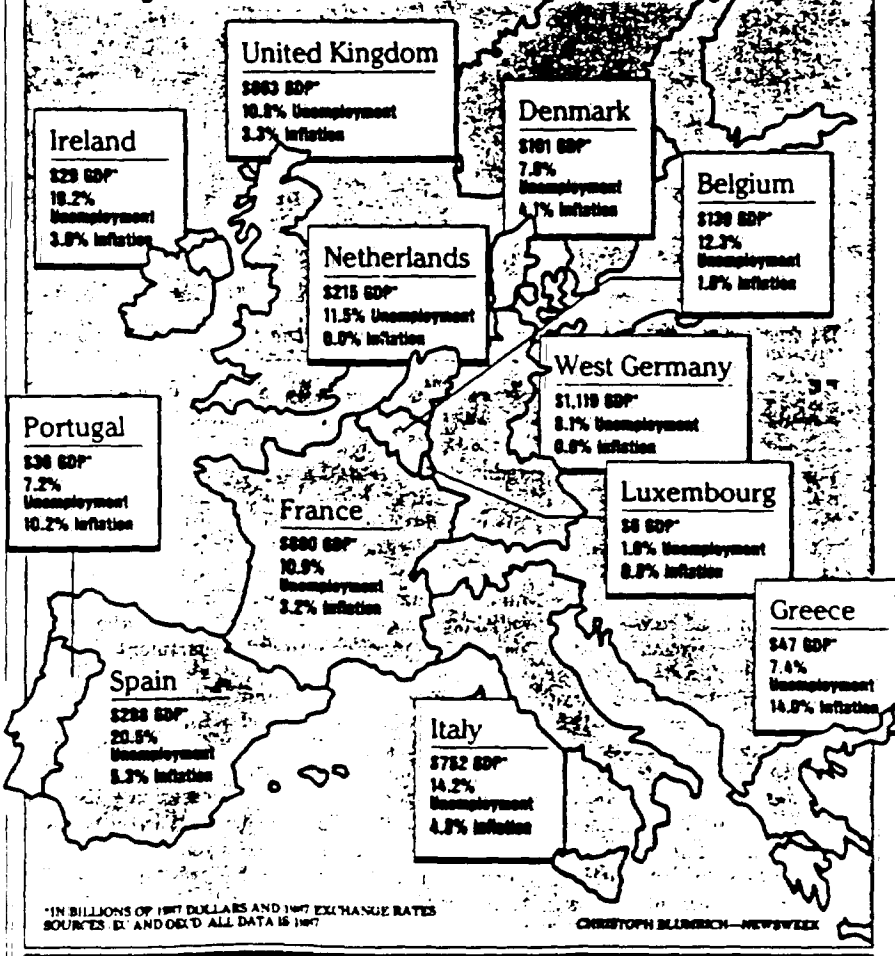


Doubts and concerns are bursting into the open: Farmers on a protest march in Brussels

'Europe Without Frontiers'

The European Community's "1992" project calls for bringing down the remaining trade barriers within the

12-member EC—and joining 12 economies that are at different stages of development and strength

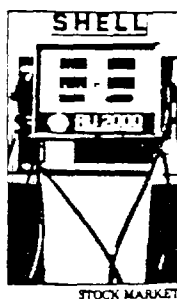


* France, West Germany, Italy, Belgium, Netherlands, Luxembourg, Denmark, Ireland, United Kingdom, Greece, Spain and Portugal

unnecessary to the building of a common market. And she derides the idea that 1992 might be a first step toward a European federation or a United States of Europe.

Thatcher contends that what she and her colleagues authorized almost three years ago was a pragmatic attack on the remaining barriers to trade and services in Europe. Nigel Lawson, Britain's Chancellor of the Exchequer, argues that, to achieve the goals of 1992, there is no need even to eliminate frontier posts, which will remain useful for catching drug traffickers and terrorists. The Commission insists that the single market would collapse if different member states continue to apply widely varying sales and value-added taxes. Thatcher replies that if sharply differing tax rates are not sustainable, "market forces" will inevitably solve the problem. As for a central Euro-bank with real powers to control ex-

The Cost of Gasoline



PRICE OF A LITER OF GASOLINE
IN DOLLARS

Italy	.98
Denmark	.91
France	.79
Netherlands	.74
Spain	.66
United Kingdom	.65
West Germany	.53

change rates, Thatcher contends it has nothing to do with the 1992 project and should not be brought up, since it would only confuse the issue.

Thatcher's opposition to the 1992 plan enrages its proponents. The Brussels Euro-cracy is proposing 285 complex regulations

covering subjects that range from trade in bull semen to new rules for banks and insurance companies throughout Europe. Jacques Delors, the French socialist who heads the European Commission, is calling for even more changes, including a powerful European Central Bank and a common currency, which he contends will be needed to make the single market work.

Whatever the outcome, Thatcher has fixed the parameters of a grand European debate. She has demonstrated quite clearly that some of the proposals now up for discussion go far beyond the practical goal of a single market. The main issue as she sees it is the conflict between the sovereignty of individual nation-states and the dream—perhaps



The drum roll has already begun: Checking motorists at the Franco-Belgian border

Hard Times at a French Customs Post

Michel Bizoux is a French customs officer. He wears his navy blue uniform with obvious pride. He joined the Customs Service in 1980, at the age of 21, and wants to stay in until he retires. Five years ago Bizoux and his wife, Brigitte, built a house just a mile from his post—the Jeumont customs office on the French side of the Franco-Belgian border. But as a result of Europe's push to establish a truly common internal market, Bizoux's comfortable career there is at risk. Since 1983 the staff at Jeumont has been

reduced from 37 to 20, and the once bustling post already wears a deserted look. Now Bizoux faces the unwelcome possibility of reassignment and fears that he may have to sell his home. "I've become part of the furniture around here," he says sadly.

If the European Community meets its self-imposed deadline, all of France's 21,000 customs officers will disappear from border posts by Dec. 31, 1992. Some will still be needed to shuffle paper in Paris and in provincial capitals. Others will be as-

signed to "mobile brigades" used to catch cross-border drug traffickers and terrorists inside French territory. But many will be forced into early retirement or assigned to dull jobs in other government departments. The drum roll has already begun. France has eliminated 350 customs jobs this year, and another 400 will be cut in 1989.

Jeumont itself looks increasingly like a relic of the past. In the post's heyday, customs officers had to keep tabs on a busy flow of cars, trucks and trains. Business began to

slow down in 1972, when a new expressway from Paris to Brussels bypassed Jeumont by 22 miles. And since 1983 another customs station 14 miles distant has been responsible for all transeuropean passenger trains. But after France, Germany and the Benelux countries signed an open-borders agreement in 1985, business at Jeumont fell off sharply. The post is still open 24 hours a day, but its hours may soon be drastically cut. Three of six neighboring customs posts have already closed.

Easier border crossings will be a boon to most European travelers and businesses. But the trend represents a personal trauma for people like Bizoux and his colleagues. Even so, most French customs officers believe that they still have a future. In addition to carrying on the fight against drugs and crime, they think about the European Community's long record of missed deadlines. "The [bureaucratic] problems won't all be solved by 1992," predicts Hervé Faveret, a regional inspector of the French Customs Service. Indeed, many veteran customs officers say that they expect to be searching automobile trunks and stamping passports well into the next century.

MEGGAN DIBBY in Paris

an elusive dream—of a European federation. Even pan-Europeanists who disagree with Thatcher admit that her speech in Belgium helped to clarify matters. "Everything is out in the open now," says Peter Ludlow, director of the Centre for European Policy Studies in Brussels.

Foot dragging: French President François Mitterrand pictures himself as a far more convinced and energetic "European" than Thatcher. But French foot dragging on some practical points could delay the 1992 project as much as Britain's ideologically driven opposition. Of all the problems facing the Eurocrats, the toughest is that of harmonizing value-added and excise taxes in the EC countries. At present, consumption taxes vary enormously among the member nations. A bottle of whisky is taxed 36 times as heavily in Denmark as in Greece. Books, food and baby clothes are not taxed at all in Britain. In France, consumers pay a 28 percent "luxury tax" on new automobiles.

France and the Brussels Commission disagree on how to bring those differing rates into line, and how quickly to do it. The Commission argues that once frontier barriers are abolished, widely differing rates will cause economic chaos. Crowds of Danish shoppers will cross the German border to buy goods that have lower taxes than they would at home. French consumers will continue to buy their cars in Brussels, as many do now: they can save \$1,600 on the price of a Citroën Visa, for example,

which lists at \$9,000 in Paris. Ever larger contingents of British day trippers will troop to Calais and Dunkirk on cheap cross-Channel excursions to load upon cigarettes and booze. Across Europe, low-tax countries will prosper; businesses in high-tax countries will go under.

Despite such cries that chaos will occur, French Prime Minister Rocard argues that the only other big source of government revenue—income taxes—is "increasingly and justifiably ill accepted by public opinion." He describes the complex value-added tax as "the only revenue source with a

of their revenue from indirect taxes, and so they both oppose any drastic tax harmonization. To complicate the picture further, the English and Danes insist on maintaining high cigarette and liquor taxes—claiming that the danger to their citizens' health is the reason. Greece, Italy and Spain want to keep those same taxes low, to please winegrowers as well as consumers.

An equally thorny issue that Europe must tackle on the road to 1992 is how—and whether—to provide a special statute for "European companies." For decades European businessmen have urged the cre-

future." He has served notice that he will fight the current Commission proposal for two uniform ranges of VAT—a 4 to 9 percent range for basic necessities such as food and heating oil and a 14 to 20 percent range for other products. French officials calculate that it would cost their government almost \$10 billion a year if there were uniform VAT rates. (The Eurocrats counter that argument with the claim that France would gain almost as much by raising its low taxes on cigarettes, liquor and wine.)

A complicated picture: The British and French, who are so often on opposite sides of European issues, are allies on this one. The main reason that the United Kingdom opposes uniform value-added taxes is that it would mean that food, books and baby clothes, which account for about 30 percent of Britain's retail trade, would now be taxed. Ireland and Denmark both derive a large share



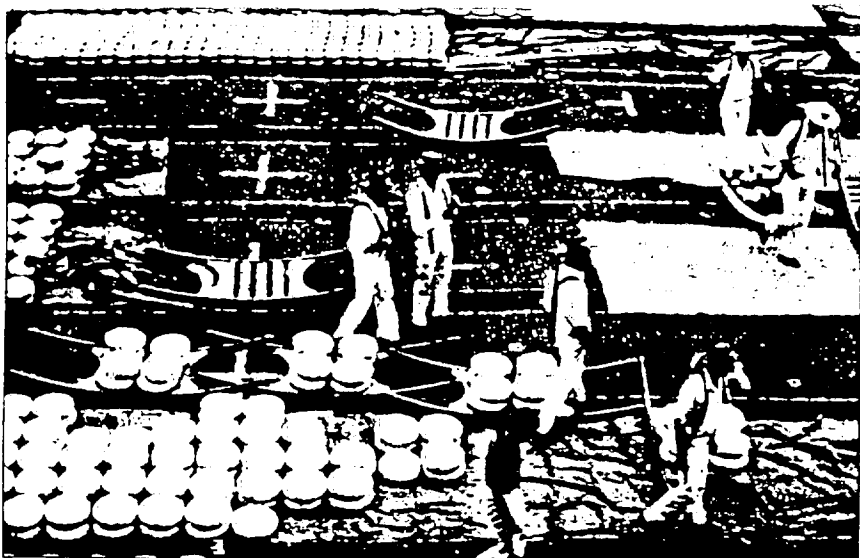
Special interests: Pig farmers protest low prices in Madrid

ORTEGA—REUTER POPPER/PHOTO



KUCH—CONTRAST/PICTURE GROUP

Threatened economies in Europe's Mediterranean sun belt: Sicilian job-seekers throng an unemployment agency in Palermo



FRANCOIS LE DIASCORN—RAPHO

A gain for consumers throughout the Community: Dutch cheeses being readied for market

ation of a formula that would allow Euro-multinationals to operate all their subsidiaries under a single body of commercial law. European labor unions see a standard company law as a heaven-sent opportunity to broaden and extend employees' rights throughout the Community. Ideally, they

would like to have the new law modeled on West German labor law, under which workers have a right to elect between one third and one half of the members of their companies' supervisory boards.

Predictably enough, Thatcher dismisses the idea as Utopian "social engineering."

By contrast, the socialist French government supports the European Commission's proposal for a strong company law along West German lines. Zygmunt Tyszkiewicz, general secretary of the European federation of employers' groups, supports the general idea of a company law, but says that the one now under consideration "is being made for the wrong reasons. It should be driven by the need for an open market, not by extraneous social considerations."

Worker guarantees: The issue is sure to be passionately divisive. "There will be no single market unless it has the backing of the workers," warns Ernst Breit, leader of the federation of West German labor unions. On the other side of the argument, Thatcher and her allies will never accept a wholesale extension of West Germany's *Mitbestimmung* ("codetermination") process. The Commission has already hinted that it will compromise with a law that guarantees workers full information on major company matters and the right to advise, but not vote, on important company decisions. But even that may be too much for European conservatives to swallow.

Closely related to the problem of work-

The Americans and 'Fortress Europe'

Business is booming these days for John Meyer, an American management consultant in Düsseldorf—but he isn't happy about it. For 26 years Meyer has been an adviser to U.S. multinational firms in West Germany. Now, as Europe races to knock down remaining barriers to a true common market, many of his clients are running scared. "I don't like the way things are going at all," he says. "There's a real danger that Europe will become significantly more protectionist after 1992. As the wall goes up, U.S. companies will be frozen out."

To many Americans, the edifice that Europe's master builders call "1992" looks more like "Fortress Europe." Businessmen and U.S. officials in Washington worry that a new "Europrotectionism" will emerge in 1992 along with a unified market. "My European counterparts say, 'No, no, a thousand times no—we have no desire to be protectionist,'" says U.S. Trade Representative Clayton Yeutter.

"Unfortunately, bureaucrats [at the European Commission headquarters] in Brussels are drafting regulations that move in a counterdirection." Says Meyer: "With 1992, trade disputes will be enormously magnified. The prospect is for feuding trade blocs—the United States against Europe, the Europeans versus the Japanese. Businessmen will be caught in the middle."

Those worries may be exaggerated. By and large, American multinationals that are well established in Europe will enjoy the same bright prospects for growth as the Europeans themselves. "I don't see any threat at all," says Ursus Jaeggi, a senior executive for Du Pont Co. in Geneva. "A barrier-free Europe will be more prosperous and we will benefit." Pierre Lougins, a vice president of Monsanto Europe—Du Pont's giant rival—is also optimistic. "We sell products manufactured exclusively in Europe," he says. "We needn't worry about import barriers."

Some American companies go so far as to suggest that, after 1992, they will dramatically enlarge their share of the European market, if not dominate it. Ford Motor Co. of Europe has concluded that 1992 is a heaven-sent opportunity to beat the foreign competition. "It will enormously simplify our busi-

ness," explains Jan Candries, Ford's director of European affairs in Brussels. For example, to sell a truck within the European Community at the moment, Ford must meet dozens of separate standards—all varying from country to country. These regulations govern everything from the width of the vehicle's headlights to the length of its wheel base. "Harmonizing" these differences into a single Europewide



ED KASHI

A transatlantic investment rush: Producing a silicon wafer

ers' rights is the emotional issue of health and safety standards. Danes, who take pride in having the most rigorous standards in the Community, are resisting what they see as the drift toward the lowest common denominator. They fear, for example, that supermarkets in Copenhagen may soon start stocking toys manufactured cheaply in the southern EC countries and decorated with lead paint. Last month Denmark won an important victory in the European court when the judges upheld a Danish law banning the import of soft drinks and beer in plastic bottles. That judgment seemed to indicate that a member country could protect its citizens' safety and the environment even at the cost of restraining intracommunity trade in Europe.

All that considered, the basis for most 1992 legislation is "mu-



Tax of the vine: Harvesting grapes in France

tual recognition of norms and standards." The general idea is that, if a certain product is manufactured in England and declared safe for English consumers, it can then be sold anywhere else in the Community. The approach follows a 1987 judgment by the European court, which struck down a 470-year-old German statute banning any additives in beer—a law that German brewers had exploited to block imports from their French competitors. Clearly, "mutual recognition" is easier than trying to bring wildly differing norms into one common standard. A high-level Community working group spent five years trying to define "white bread" before giving up and declaring that white bread was anything so designated in the country where it was baked.

Bitter argument: In a single market, consumers should be the big winners. And yet consumer groups are deeply worried about what they see as a trend toward increased protectionism after 1992. Tony Venables, head of the European Consumers Union, says the Commission has recently approved "one protectionist measure after another." It plans to slap a 30-percent tax on imported videotape recorders. France

standard will help Ford cut costs and push forcefully into new markets. "We're already one of the lowest cost automobile producers in Europe, including the Japanese," says Candries. "We have 11 percent of the market now. After 1992, we'll considerably increase our share."

For every U.S. firm that's bullish on 1992, another is not. By rights, giant American Express should expect to thrive.

"We've done business in Europe for 100 years," says Julian Oliver, an American Express vice president in London. "We have 10,000 employees in Europe and more than 3 million cardholders. We're thoroughly European." But being European, honorary or otherwise, is no longer enough. European Commission officials writing the 1992 regulations in Brussels speak of differing treatment for companies oper-

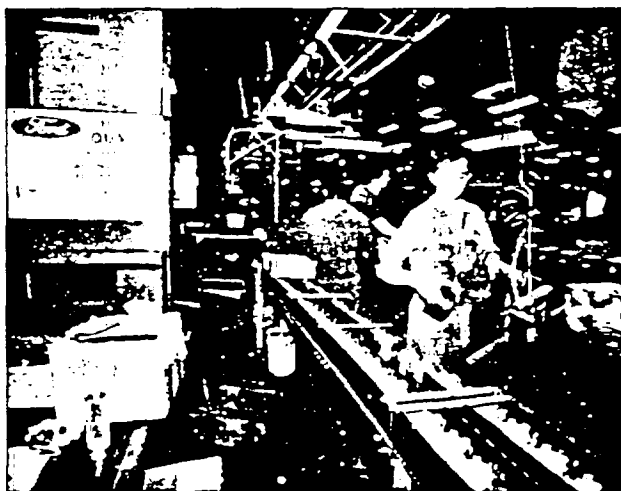
ating in Europe "pre-1992" and "post-1992." They talk of "reciprocity" and "transitional rules" and discuss ways to ensure that the benefits of 1992 go to Europeans and not to their foreign competitors. American Express and other U.S. financial-service conglomerates are particularly worried that they may be hurt by new rules aimed at protecting Europe's bankers. "It's a frightening prospect," says Oliver. "The European Community has not fully thought out the external implications of its 1992 regulations."

The United States would hardly be willing to dismantle its interstate banking laws to suit Europe, any more than the Japanese would promise to give European automakers a guaranteed share of their domestic car market in return for assured access to the Continent. The prospects for a post-1992 trade spat—with quotas, tariffs and import duties—are high. American multinational companies already established in Europe would suffer the fewest casualties. Small- and medium-size exporters

with no European base could be hardest hit.

The sense that Europe's doors may soon slam shut has spurred something of a transatlantic investment rush. Major multinationals are beefing up their presence on the Continent: General Electric recently committed \$1.7 billion to a new plant in Spain, and AT&T has set up its first major European office in Brussels. Small- and medium-size American exporters also are scrambling to establish a European foothold. "With 1992 on the horizon, we're seeing a lot of new ventures, a good number of them involving relatively small companies," says Paul Pilkauskas, a commercial officer at the American Embassy in Bonn. To avoid the cost of building their own manufacturing plants, many are teaming up with European partners. Others are buying out European companies in the same line of business or licensing their products to local distributors. All are moving with one eye on the opportunities that 1992 offers—and the other eye on the threat of protectionism.

MICHAEL MEYER in Bonn



An opportunity to beat the competition: A Ford factory in France



GOT—COLLECTIF-JS PICTURES

The elusive dream of a continent without borders: Farmers in southern France destroying lower-priced fruit imported from Spain

has gained permission to protect itself against small color-TV sets imported through other European countries. A bitter argument is currently raging in Brussels about how much "European content" there must be in a given product for it to count as "European." The United Kingdom contends that a Nissan car produced in England with 60 percent English-manufactured components should benefit from all the advantages of a free internal market. The French government, along with Renault and Fiat, claim that any car with more than 20 percent of its components from outside the EC should be taxed as if it were foreign.

This kind of debate, with its protectionist overtones, has produced something resembling panic among Europe's trading partners. "European businessmen don't want to lose the gains they have already made," says Alfred Kingon, the American ambassador to the Community, "and that means they have to keep out third-country imports." Kingon and other third-country representatives have mounted an energetic lobbying and public-relations campaign to keep the European market open. The Japanese are worried that low quotas for Japanese cars in some EC countries—3 percent

of the market in France, 3,500 a year in Italy—may spread to the community as a whole. Europeans like the Swiss and the Swedes, who are not members of the Community, are concerned that the virtually free access to the Community market that they have at this time may be curtailed after 1992. A report earlier this year from the Federation of Swedish Industries predicted that the single market "will negatively affect Sweden's whole industrial structure and economic growth—and, therefore, living standards." Delors, the Commission president, fanned foreign fears when he said recently: "We are not building a single market in order to turn it over to hungry foreigners."

For the United States, a key issue is the

future shape of Community-wide banking regulations. The Commission's buzzword for relations with foreign countries is "reciprocity," a principle that sounds fair enough but one that could spell disaster for American banks and businesses. If the reciprocity concept is narrowly defined, the Europeans could refuse to allow U.S. banks to operate in more than one Community country—because American law limits both native and foreign banking activity when it crosses state lines. The fear is that one Greek bank, for example, could ruin the financial arrangements of the Western world if it applied to operate in both New York and Los Angeles, was refused, then decided to push the "reciprocity" argument to its limits. Specifically, the Greek bank could file a complaint against the United States and prevent the establishment of any further American banks *anywhere* in the Community—not just in Greece.

Most Community officials discount such fears. "The idea of a Fortress Europe is simply absurd in our view," says Horst G. Krenzler, director general of the EC's external trade division. "A third of our salaries depend on trade." Edith Cresson, France's minister for European affairs, objects when she hears foreign criticism of the 1992 project. "We are not building Europe *against* anybody, including the United States," she says. "I want the Americans to know they are free to do

The Cost of Cigarettes



PRICE OF MARLBORO CIGARETTES
PACK OF 20, IN DOLLARS

Denmark	\$3.62
United Kingdom	2.61
West Germany	2.14
Italy	1.98
Netherlands	1.77
France	1.57
Spain	1.48

anything they want in the United States, but I don't want them telling us what to do in Europe. We're not a colony, after all." The Brussels Commission does take outside criticism seriously. Last week it issued a formal policy statement saying that the single market would increase total world trade and would benefit third countries as well as EC members.

An unquestionable good: Although opposition from foreign governments is important, it is less so than the fears and reservations of the Europeans themselves. So far the vast majority of voters in the Community regard the approaching single market as an unquestionable good, like virtue or motherhood. But increasingly, individuals and groups are beginning to calculate the pounds, francs and Deutsche marks that 1992 will put in—or take out of—their pockets. As a general rule, dynamic, well-managed companies that already have considerable exports look forward to the enlarged market with optimism. Companies and professional groups that enjoy monopoly positions in their own markets and have little exporting experience are at risk. And they are beginning to recognize it.

Oddly enough, sheer size has little to do with an industry's prospects in the single market. The vast Fiat automobile company is almost certain to lose a big chunk of its domestic market share simply because it already sells six out of every 10 cars registered in Italy. Smokestack industries like steel and shipbuilding will be just as badly off in one big market as in 12 smaller ones. Germany's rich, powerful banks and insurance companies will have to step briskly to compete with their more flexible and aggressive British competitors. Shoemakers and toy makers in the southern tier of the EC could do well in 1992 if the larger market remains protectionist. But they will go under if the external borders are flung open to competition from the Third World and the newly industrialized countries.

Some professions will be certain losers. Community officials calculate, for example, that 80,000 customs officials throughout Europe will be laid off or reassigned when the borders open. German truck drivers, who have long benefited from one of the cushiest monopolies anywhere, will lose business to the go-go Dutch trucking industry. France's Balzacian corps of "notaries" are likely to lose their monopoly on executing real-estate sales and wills. If so, they will either convert themselves into humdrum

The Cost of Whisky



PRICE OF 100 ML OF WHISKY
IN DOLLARS*

Denmark	\$20.17
Netherlands	16.09
United Kingdom	15.86
France	12.75
West Germany	10.15
Spain	9.79
Italy	6.32

*JOHNNIE WALKER RED LABEL
SCOTCH WHISKY

real-estate agents (as many have already done) or go out of business. Duty-free shops will lose most of their charm when sales taxes are the same everywhere, and as a result, their employees face a dim future. So do the shopkeepers at Calais who have made fortunes offering bargains to day trippers from the south of England.

The most seriously threatened economies are those of Europe's Mediterranean sun belt. With some exceptions, industries in Greece, Spain, Portugal and Italy's Mezzogiorno produce lower-quality goods than do their northern competitors. They are also less efficient. Their one competitive advantage consists in lower labor costs and lower fringe benefits, and that edge will be eroded as the Community strives to harmonize working conditions and workers' rights. Paradoxically, though, it is the southern countries that have shown the most enthusiasm for a single market. Spaniards and Greeks support the 1992 idea largely because the push is accompanied by an enormous

north-south transfer of "structural funds," intended to improve the south's infrastructure and nurture its promising industries. These funds are in effect a form of direct aid from the northern countries, mainly Germany, France, Belgium, the Netherlands and Luxembourg. They amounted to just under \$8 billion last year, and will double to \$16 billion by 1993.

Critics point out that the provision for structural funds vio-

lates the free-market principles that are supposed to be the vital foundation of the whole 1992 project. In effect, the funds amount to direct subsidies for inefficient industries in the Mediterranean south. And they are by no means the only market-distorting subsidies the EC condones. The EC's Common Agricultural Policy is built on public payments to farmers who consistently overproduce unneeded crops. Just last week, the Commission approved an injection of up to \$4 billion in capital for Italy's troubled Finsider steel company—just the kind of industry that the Community's supply-side theorists say they want to see fade away. "They call 1992 an historic exercise in deregulation," says a U.S. official in Brussels. "But if you look a little closer, it's the same old pork barrel as before."

Growing opposition: Europe will not give up protectionism overnight. Nor is the Community likely to pass the 285 specific directives that compose the 1992 program by the stated deadline. Opposition to details is

sure to grow stronger as the deadline date approaches. The path to the single market will be paved with sloppy compromises and missed deadlines. But it will happen. Even the most rabid opponents of various elements in the 1992 package say they support the idea of a single market. These supporters include the American and British governments and European labor and business alike. Simply put, the construction of a single European market with 320 million consumers is an idea whose time came long ago. Inevitably, one day a Europe without internal borders and customs formalities will emerge. Europe's economies need the single market to compete and survive. And it is the absolute precondition for accomplishing the ultimate European dream—the vision of a real political union that will restore Europe to a world power.



GRANVEAUD—COLLECTIF JB PICTURES

Euphoria: Cheering for the European Community

SUMMARY OF PROVISIONS

by
The International Trade Administration
U.S. Department of Commerce
(December 11, 1987)

1. Overview

Each year the United States and Canada exchange more goods, services and capital than any two countries in the world. Bilateral trade in goods and services exceeded \$150 billion in 1986. In addition, the accumulated direct bilateral investment through 1986 totaled almost \$67 billion.

To enhance this unique commercial relationship, the United States and Canada have initialed the elements of a free trade agreement (FTA). If approved and implemented the FTA will facilitate American-Canadian business by:

- Eliminating all tariffs on bilateral merchandise trade;
- Eliminating virtually all import and export restrictions;
- Eliminating or reducing many nontariff barriers to trade and investment;

- Establishing rules for the conduct of bilateral investment;
- Resolving many outstanding bilateral issues;
- Establishing principles for the conduct of bilateral trade in services;
- Enhancing the energy and national security policies of the United States and Canada;
- Facilitating business travel; and
- Establishing a timely bilateral dispute settlement mechanism.

Economic Implications

The lowering or removal of barriers to trade and investment will have strong general economic benefits for the United States and Canada. Economists in both countries

2025865385

forecast increased economic growth, bilateral trade and investment, lower prices, expanded employment opportunities, and enhanced North American (U.S. and Canadian) competitiveness in the world marketplace resulting from the FTA.

In announcing his intention to enter into the agreement, President Reagan said: "This historic agreement will strengthen both our economies and over time create thousands of jobs in both countries. It will serve as an important model for other nations seeking to improve their trading relationships. In many respects it will also serve as a model for the Uruguay Round of multilateral trade negotiations."

FTA Approval Process

On October 3, 1987, President Reagan notified Congress that he intends to enter a free trade agreement with Canada on January 2, 1988, contingent upon successful conclusion of the negotiations. After signature, the agreement and implementing legislation will be formally presented to the House and Senate. Congress will consider the bill under the "fast track" negotiating authority. Under the "fast track" Congress has 60-90 legislative days to approve or disapprove the bill, with no amendments permitted. A simple majority of both the House and Senate is required for approval.

If approved by the United States and Canada, the free trade agreement is expected to enter into force on January 1, 1989.

FTA Provisions

The FTA is a broad agreement which will govern trade and investment between the United States and Canada for most industrial, agricultural, and service sectors. The following summaries present background information and substantive detail on the major provisions of the agreement. Since the pact is currently in draft and subject to approval procedures in both countries, the provisions outlined below should be treated as indicative rather than definitive. Individual data sheets are provided below on these issues:

Agriculture	Quantitative Restrictions
Automotive Trade	Safeguards
Culture	Services
Customs Matters	Standards
Dispute Settlement	Subsidies/Antidumping
Energy	Dispute Settlement
Financial Services	Tariffs
Government Procurement	Temporary Entry for Business
Investment	Wine and Distilled Spirits

For Further Information

Contact the U.S. Department of Commerce, Office of Canada (Room 3033), Washington, D.C. 20230, or call (202) 377-3101; or the Office of Public Affairs, Office of the U.S. Trade Representative, 600 17th Street, N.W., Washington, D.C. 20506, or call (202) 395-3230.

2. Agriculture

Bilateral Benefits: Canadian and U.S. agricultural producers will have increased opportunities to market their products in the future with no tariff barriers and with fewer non-tariff barriers.

Overview: Various barriers to trade in agriculture have arisen in recent years in an attempt to stabilize the agricultural economy. Quotas, import licenses, technical requirements, and subsidies have all had a negative effect on trade in agricultural products. The FTA provides for a number of liberalizing measures in an era of increasing protectionism.

FTA Provisions

- The two sides have agreed to a comprehensive package that will eliminate all agricultural tariffs within 10 years.
- Canadian import licenses for U.S. wheat, barley, oats and grain products will be eliminated when support programs in both countries are equal. Both sides reserved the right to impose or reimpose restrictions if there is a substantial change in the support level of either party.
- The U.S. has agreed not to impose restrictions on products containing less than ten percent sugar, for purposes of protecting the U.S. sugar support program.
- For the first twenty years, either side may temporarily reimpose duties on horticultural products up to pre-FTA levels in certain low price situations.
- Canadian import quotas for poultry, poultry products and eggs will be increased.
- Subsidies provided by the Canadian Western Grain Transportation Act for products moving through western Canadian ports to U.S. markets will be eliminated.
- The two countries will exempt each other from their

2025865386

respective meat import laws, subject to certain conditions.

- Both sides agreed that their primary goal with respect to agricultural subsidies is to achieve, on a global basis, the elimination of all subsidies which distort agricultural trade and agreed to work together to achieve this goal, including working together in the Uruguay Round.
- Both sides have agreed to work together to harmonize to the greatest extent possible technical regulations affecting agricultural food and beverage products.

3. Automotive Trade

Bilateral Benefits: The U.S. and Canada have agreed to the removal of tariff and nontariff barriers which will eliminate certain trade and investment distorting practices. They also agreed to a new, tougher rule of origin. The combined effects of these changes will be to encourage greater production of motor vehicles and sourcing of automotive parts and components in North America and to create greater symmetry in our bilateral trading relationship.

Overview: Under the U.S.-Canada Automotive Products Trade Agreement of 1965 ("Auto Pact"), 95 percent of bilateral automotive trade with Canada already moves duty free. As a result of the FTA, all automotive trade will move duty free. Automotive products accounted for over one-third, or \$46 billion, of our total bilateral trade in 1986.

FTA Provisions

- All tariffs are to be eliminated by January 1, 1998.
- Canada's export-based duty remission program (duty waivers conditioned on exports) will be eliminated immediately on exports to the United States.
- Canada's production-based duty remissions (duty waivers conditioned on meeting local content requirements) will be phased out.
- Existing duty remission schemes may not be enhanced or extended and no new ones may be put in place.
- The FTA will not change the Auto Pact; however, no new firms may qualify for Auto Pact or Pact-like benefits, such as duty-free access to imports of parts from third countries. Each party will endeavor to administer the Auto Pact in the best interests of employment and production in both countries.

- A new, tougher rule of origin was adopted that combines the concepts of change of tariff heading and substantial transformation; this rule is, for automobiles, 50 percent North American direct cost of manufacturing.
- Canada's embargo on used motor vehicles will be phased out.
- A select panel will be established to assess the state of the industry and to recommend public policies and private initiatives that would contribute to increased competitiveness.

Note: See separate paper on "Customs Matters."

4. Culture

Bilateral Benefits: Canada faces no constraints on its ability to promote the development of Canadian culture through economic measures. The United States can take measures of equivalent economic effect to respond to actions taken by Canada in the cultural area.

Overview: The U.S. recognizes the importance to Canada of maintaining its cultural identity. At the same time, however, the U.S. wants to ensure that Canadian cultural policies do not constitute an unnecessary barrier to U.S. trade.

The U.S. and Canada have agreed that certain cultural areas are not subject to the specific provisions of the agreement, except for the elimination of tariffs. (Cultural industries are defined as publication, distribution, sale or exhibition of: books, magazines, and newspapers; film and video recordings; audio or video music recordings; radio, television and cable broadcasting.) Both parties can respond to actions taken by the other party that would be inconsistent with the FTA if cultural industries were covered. In addition, Canada has agreed to alter certain discriminatory practices.

FTA Provisions

- Explicit recognition that cultural industries are exempt from the agreement.
- To respond to actions that would be inconsistent with the FTA, the other side can take measures of equivalent economic effect.
- Elimination of tariffs on printed matter and recordings.
- Canada has agreed to provide copyright law protection.

for the retransmission of copyrighted programming effective no later than January 1, 1990.

- Canada has agreed to remove the "print in Canada" requirement for eligible advertising expenses which can be deducted for income tax purposes.

Note: See separate paper on "Investment."

5. Customs Matters

Bilateral Benefits: The customs chapter establishes a rule of origin to ensure that the tariff benefits of the FTA are restricted to U.S. and Canadian goods. It includes rules on certain duty programs to prevent distortions to trade and investment.

Overview: The customs chapter defines what products qualify for special tariff treatment under the FTA and limits the use of duty drawback, duty waivers, and Foreign Trade Zones.

FTA Provisions

- The rule of origin for eligibility for tariff treatment under the FTA for articles incorporating third-country materials will be based on specified changes in tariff classification under the new Harmonized System of Tariff Nomenclature. Precise rules, by tariff line, specify the necessary change in classification to qualify.
- Certain imported articles must incur 50 percent of their manufacturing costs in one or both countries to be eligible for FTA tariff treatment.
- Duty drawback for bilateral trade will end January 1, 1994, with some special exceptions.
- Goods produced under programs that confer benefits similar to drawback and exported to the other country (such as Canada's inward processing program or U.S. Foreign Trade Zones) shall, after January 1, 1994, be treated for tariff purposes as if they were entered for consumption in the producing country.
- Duty waivers linked to performance requirements generally will end January 1, 1998. When either the United States or Canada grants a company-specific duty waiver to a designated firm or individual, it will either make the duty waiver generally available or end it if the waiver hurts the commercial interest of the other country.

- Customs user fees will be phased out by January 1, 1994.

6. Dispute Settlement

Bilateral Benefits: Both sides will benefit from effective, expeditious dispute settlement procedures.

Overview: The U.S.-Canada Free Trade Agreement promises to broaden the level of business activity between the world's largest commercial partners and bring substantial economic returns to both countries. Both parties anticipate questions of interpretation and application will arise as they adjust to their new obligations. To prevent such questions from escalating and possibly derailing the Agreement, Canada and the United States will establish institutional arrangements for effective dispute avoidance and resolution.

FTA Provisions

- A cabinet-level Canada-United States Trade Commission will be created to supervise implementation of the Agreement. The Commission will meet annually for consultations and as required to defuse problems before they become full blown disputes.
- Notification and consultation procedures will reinforce the emphasis on dispute avoidance. The Commission may call on experts or mediators to facilitate dispute resolution.
- Disputes not resolved by the Commission will be automatically referred to a panel of experts for consideration. Normally, the panel decision will resolve the dispute unless the U.S. and Canada agree on an alternative solution. (Disputes regarding a safeguard action taken by either party are subject to binding arbitration.)
- If these procedures fail to produce a mutually satisfactory solution, an aggrieved party can retaliate.
- Time limits on each phase of the dispute settlement process are designed to assure the resolution within eight to nine months.
- Special provisions apply in two areas. Financial services disputes will be handled by separate consultation procedures administered by our finance ministers. Separate procedures also will apply in countervailing duty and antidumping duty cases.

Note: See separate paper on "Binational Panel Dispute

2025865388

Settlement in Antidumping and Countervailing Duty Cases."

7. Energy

Bilateral Benefits: The United States and Canada will derive economic and mutual security benefits from a strong FTA agreement that places energy trade on a free market basis. Almost all bilateral barriers to energy trade will be eliminated, providing secure access to energy supplies and markets on a nondiscriminatory basis, thereby enhancing the national security of both countries.

Additional investment will occur in both countries for energy projects that require large amounts of capital and long-term assurances that markets will not be disrupted. Because energy is a major input to industrial competitiveness, both countries' international competitiveness will be greatly enhanced by a strong energy agreement. Consumers will benefit from lower prices. Increased productivity will stimulate economic growth.

Overview: Canada is virtually our only foreign supplier of natural gas and electricity, and our leading supplier of oil and uranium. Bilateral energy trade totals about \$10 billion. Canadian energy imports are especially important to the United States because of their security compared with other import sources. Conversely, secure access to U.S. markets for energy products is especially important to Canada.

FTA Provisions

- The energy chapter includes: crude oil, petroleum products, natural gas, electricity, coal, and uranium.
- The FTA provides for free bilateral trade, non-discriminatory access to energy supplies, and secure markets for exports.
- Both countries have agreed to prohibit restrictions on imports or exports, including quantitative restrictions, export or import taxes, minimum import or export price requirements or any other equivalent measure, subject to very limited national security and short supply exceptions. If short supply actions are taken, the parties must share available supplies proportionately among historic users in the two countries.
- Both countries will eliminate restrictions on imports and exports of uranium. Canada will eliminate various practices that discriminate against energy exports to the United States. The United States has agreed to

make a limited amount of oil from Alaska's North Slope available to Canada, subject to the requirement that such oil be transported in U.S. tankers.

8. Agreement on Financial Services between Canada and the United States

Bilateral Benefits: With the growing interdependence of financial markets reflecting deregulation, liberalization, and technical innovation, the U.S.-Canadian Financial Services Agreement helps further integrate our two financial markets. U.S. and Canadian financial institutions will participate in all future liberalization of both our financial markets. The Agreement establishes a consultative mechanism to oversee liberalization and resolve any potential problems.

Overview: The Agreement on Financial Services is first bilateral agreement of the United States covering the entire financial sector. It removes essentially all existing discrimination faced by U.S. financial institutions operating in Canada, allows the flexibility to acquire Canadian financial services firms, improves access between our markets, and allows financial firms on both sides of the border to compete on a more equal basis. Canadian financial institutions will continue to enjoy the current treatment and open access they now receive in the U.S. financial market.

- U.S. commercial bank subsidiaries operating in Canada will be free from the current restrictions on market, share, asset growth, and capital expansion.
- U.S. insurance firms will now receive the same rights as Canadian insurance companies to diversify by establishing or acquiring federally regulated insurance and trust companies or closely held banks.
- Applications by U.S. commercial banks in Canada and U.S. securities firms to enter the Canadian securities market will be reviewed by federal authorities on the same basis (*i.e.*, prudential and regulatory) as those of Canadian firms.
- U.S. securities firms established in Canada will have the ability to diversify through a holding company structure into other financial activities such as banking and insurance.
- Canada commits (as does the U.S.) to liberalize its financial markets and to extend the benefits of its liberalization to U.S. financial institutions carrying on business in Canada.

2025865389

- The Agreement establishes a consultative mechanism between the U.S. Department of the Treasury and the Canadian Finance Department to oversee liberalization.
- The U.S. agreed to guarantee the right of Canadian banks to retain their multi-state branches that were grandfathered under the International Banking Act of 1978.
- If the Glass-Steagall Act or related acts are amended, the U.S. also agreed that Canadian financial institutions in the United States would not be excluded from any of the benefits.
- The U.S. agreed to allow Canadian banks (as well as U.S. and other foreign banks) in the United States to underwrite and deal in debt obligations backed by the full faith and credit of Canada, its provinces, and political subdivisions:
 - responds to Canadian concerns regarding the treatment of their banks and securities firms which merge in Canada;
 - is a limited new power that is consistent with the existing ability of banks to deal in securities of the U.S. Government and its political subdivisions;
 - does not undermine the basic tenets of Glass-Steagall.

9. Government Procurement

Bilateral Benefits: The government procurement chapter of the FTA expands the size of the government procurement markets which will be open to free and fair competition between U.S. and Canadian suppliers. The chapter requires the implementation of bid challenge procedures available to individual suppliers, something the United States currently provides but Canada does not.

Overview: The U.S. and Canadian governments apply various "buy national" preferences in favor of suppliers of domestic goods. These preferences inhibit — and in some cases prevent — competition from foreign products. Under this chapter, suppliers of goods which are manufactured in the U.S. or Canada and which contain at least 50 percent U.S. or Canadian content will be treated on an equal basis to suppliers of domestic goods for covered procurements.

The value of procurement opportunities covered by this chapter is estimated at approximately \$3 billion of U.S. procurement and \$500 million of Canadian procurement. As a result of the new opportunities offered by Canadian entities under this chapter, procurement opportunities in Canada for U.S. exporters are increased by more than 100 percent. Viewed in conjunction with the Government Procurement Code, this chapter will now allow U.S. exporters to compete on a nondiscriminatory basis for all Code-covered procurements over \$25,000.

FTA Provisions

- "Buy American" and "Buy Canadian" restrictions are eliminated on the procurement of goods by U.S. and Canadian entities covered by the GATT Government Procurement Code between the Code threshold (for 1986, \$171,000) and an FTA threshold of \$25,000; and are subject to the same exclusions and exceptions as those covered by the Code.
- Principles are established to guide bid challenge procedures. These include a requirement that a reviewing authority with no substantial interest in the outcome of the procurement be responsible for deciding bid challenges.
- Each party must provide transparency in its procurement process. A party must provide public notice of all the criteria it intends to use in evaluating a bid (including offsets) and must award the bid based on those criteria.
- At the conclusion of current multilateral negotiations on the GATT Code, there will be an opportunity to expand coverage of this chapter by further negotiations with Canada.

10. Investment

Bilateral Benefits: The investment agreement in the FTA will help assure an open and secure environment for foreign investment in both countries that will maximize the economic gains from free trade. Investor rights will be protected through a long-term agreement that assures that new discriminatory barriers to investment will not be erected and the rules of the game will not be changed unfairly. A strong investment agreement is a vital element of the FTA; its reciprocal guarantees will protect investors in both countries. It will also provide the right environment to spur the private sector in both countries to maximize the economic gains available from free trade well into the next century.

Overview: The United States has about \$50 billion in direct investment in Canada. Canada has about \$18 billion invested in the United States. During the 1980s, U.S. direct investments in Canada and Canadian direct investments in the U.S. increased by roughly \$5-6 billion.

FTA Provisions

- Investments will be granted national treatment on and after entry so that future discrimination based on nationality will be ended. Existing restrictions are grandfathered.
- Prohibits new policies setting minimum national equity participation or forced divestiture; establishes internationally accepted standards for expropriation and compensation; and provides for the free transfer of profits, proceeds of sales and other business activities.
- Prohibits the future use of most performance requirements imposed on U.S. investors and on third country investors when there could be a significant impact on U.S.-Canadian trade.
- No screening of new (greenfield) business investments. The screening of direct acquisitions will be limited to acquisitions of Canadian assets of more than C\$150 million (constant dollar basis) after a phase-in period.
- Indirect acquisitions (involving subsidiaries in Canada of acquired foreign parents) will no longer be screened after a phase-in period. U.S. investors will have the right to sell, without screening, up to the new threshold of C\$150 million for direct acquisitions and without any limit for indirect acquisitions.
- Cultural industries are exempt from the FTA including the investment chapter. However, the agreement solves a key problem for investors. If Canada wishes to force divestiture of an indirect acquisition in a cultural industry, the Canadian Government will offer to purchase the cultural subsidiary at a fair, open market price independently determined.

11. Quantitative Restrictions and Other Import and Export Restrictions

Bilateral Benefits: Both countries will benefit from the general prohibition and elimination of current import and export restrictions like quotas, embargoes, and minimum price requirements.

Overview: Countries have often employed nontariff measures such as import quotas, minimum price requirements, and embargoes to limit trade. Obviously, these measures can destroy the benefits of free trade and their elimination is an essential element of a free trade area. Rules governing future measures are also a central element.

FTA Provisions

- The Canadian embargoes on used motor vehicles and used aircraft, and the U.S. embargo on lottery materials will be phased out.
- Import restrictions will not be permitted except in accordance with obligations under the GATT, which allows measures for health, safety, security, conservation and short supply.
- Export restrictions (including those for short supply and conservation reasons) may be taken but they must provide for the sharing of the resource with the other party, and they may not create price discrimination by other means.
- Existing restrictions will be eliminated, unless justifiable under the GATT, either by a timetable or immediately. Certain measures are being retained under the General Exceptions to the Agreement such as log export restrictions and U.S. Jones Act provisions relating to foreign-built ships.
- The parties have incorporated the GATT rule against internal measures that discriminate against products of the other party.

12. Safeguards

Bilateral Benefits: The FTA provides for a safeguard system (parallels Section 201 of the Trade Act of 1974 — also known as the "escape clause") to preserve the rights of workers and firms in both countries to gain relief from import-related injury while assuring U.S. and Canadian business that the trade expansion created by the FTA will not be suddenly and arbitrarily cut back.

Overview: While the United States and Canada have not used such actions against each other very often, the possibility of taking actions reduces certainty of market access. Rules on the use of safeguard actions are required in an FTA for corporate planning.

FTA Provisions

- The FTA establishes a two track safeguard system.

- The first track (bilateral relief) provides that if serious injury results from FTA duty reductions, the pre-agreement tariff rate(s) treatment may be restored. This provision can be used once per product during the transition period, for three years' duration, and the tariff must continue its staged reduction after the action expires. Actions shall not extend beyond the transition period except by mutual consent.
- The second track (global relief) provides that if serious injury arises from imports from several countries including the FTA partner, the partner taking the action has the right to include the other partner in the relief if the partner's imports are substantial and contribute importantly to the injury. This section is subject to binding arbitration following any retaliatory action. The FTA partner's imports cannot be cut back below the most recent representative base period with allowance for growth. If those imports are not substantial, they will be excluded from the initial action. If imports subsequently surge from the FTA partner, they can be included in the relief action.
- For any safeguard actions, compensation for the trade affected must be provided by the party taking the action, or the other party may retaliate.

13. Services

Bilateral Benefits: The FTA is the first international agreement governing trade and investment in services industries. It provides that future laws and regulations affecting trade and investment by the service providers (e.g., insurance, enhanced telecommunications and professions) of the other country will be nondiscriminatory.

Overview: Both the United States and Canada have relatively open markets for services. However, in the absence of international rules governing services trade, neither side has been constrained from imposing restrictions on services.

A wide range of industry sectors are covered by the agreement including: construction, enhanced telecommunications, insurance, professional services, services relating to mining and agriculture, wholesale and retail trade, tourism, management services, and other business services.

FTA Provisions

- Future U.S. and Canadian government measures such as laws, regulations or licensing requirements affecting services trade and investment will be required to provide national treatment, that is, not to discriminate between the services providers of either country.
- The right of establishment, the right to sell across the border, and greater transparency in regulations are also provided.
- The opportunity for future negotiations to increase liberalization, sectoral coverage, and other obligations.
- Future licensing and certification requirements for individual's providing services (such as accountants and engineers) will be based on competence and ability.
- Both sides will work toward mutual recognition of licensing and certification requirements.
- In architecture, both sides will review the work of professional organizations to develop mutually acceptable standards and will encourage adoption of necessary legal changes to effect mutual recognition by the states and provinces.
- In enhanced telecommunications and computer services, the agreement ensures the further development of an open and competitive market including access to and use of the basic network.
- There are annexes which clarify the application of the services agreement to architects, telecommunications, and tourism.

Note: See separate paper on "Financial Services."

14. Standards

Bilateral Benefits: Both countries will benefit from increased discipline over the use of standards-related measures so that they do not hinder trade unnecessarily. Certification and testing facilities will receive nondiscriminatory treatment in both countries.

Overview: There are legitimate public policy objectives for which technical regulations and standards-related are maintained (e.g., to protect human, animal or plant life or health; to preserve the environment; and to protect essential security interests). However, standards measures may work to inhibit trade. The FTA standards agreement builds on our mutual obligations under the GATT Standards Code.

2025865392

FTA Provisions

- At the federal level, neither party will use standards to create unnecessary obstacles to trade.
- Obstacles to trade are not created where the *demonstrable* purpose of standards-related measures is to protect health and safety, environmental, national security and consumer interests. However, such measures must not operate to exclude goods of the other country if they meet these objectives.
- Both countries will assure that testing facilities and certification bodies are treated in a nondiscriminatory manner. This paves the way for the recognition by Canadian authorities of U.S. facilities and bodies.
- Canada and the United States agree to harmonize (make compatible) federal standards-related measures to the greatest extent possible, and to promote harmonization of private standards.
- We have agreed that processes and production methods are included as standards related measures subject to the provisions of the agreement.
- Both countries will recognize each other's systems for accrediting testing labs.
- Both countries will provide for enhanced transparency in the regulatory process with additional information exchange and a guaranteed 60-day comment period on proposed regulations at all levels. Similar provisions will apply for state, provincial, and private standards activities at a "best efforts" level.

15. Binational Panel Dispute Settlement in Antidumping and Countervailing Duty Cases

Bilateral Benefits: Each country will continue unilaterally to administer and enforce its countervailing duty and antidumping laws. However, special binational dispute settlement panels will review whether final administrative decisions are appropriate under national laws.

Overview: National antidumping and countervailing duty laws are designed to address the unfair trade practices of injurious dumping and government subsidies to industries. This section of the FTA provides for a binational mechanism to replace review by national courts of certain final antidumping and countervailing duty decisions. Canada believed that binational review of unfair trade cases affecting bilateral trade was an essential element of the FTA.

FTA Provisions

- Upon request of a government or a private party to the case, the panel will review, based on the administrative record, final determinations in antidumping and countervailing duty investigations and administrative reviews. The panel will apply both the law and the standard of judicial review applicable under the domestic law of the importing country. Under the FTA, panel decisions will be binding. Private parties will participate before the panel, just as they would now participate in court review.
- The panels will be set up case-by-case, with two persons appointed by each side, usually from a roster of experts. The fifth person will be mutually selected. At least three of the five members of each panel, including the Chairman, will be lawyers.
- The binational review arrangement will be in place for five years, during which time the parties will work on improving the mechanisms to deal with subsidies and dumping in the FTA. There is an automatic two-year extension if no new system has been developed at the end of five years. Failure to agree to a new regime at the end of seven years would allow either party to terminate the Agreement.
- The binational panel process would apply to final determinations made after January 1, 1989 in investigations or administrative reviews.

16. Tariffs

Bilateral Benefits: All bilateral tariffs will be eliminated in stages by January 1, 1998. The removal of tariffs will increase two-way trade and lower costs to consumers in both countries, thereby creating a single continental market of 265 million people.

Overview: Approximately 75 percent of bilateral trade, currently in excess of U.S. \$120 billion, moves free of duty. The remaining 25 percent, however, is subject to tariffs. Canadian tariffs average about 9-10 percent or about twice the U.S. average of 4-5 percent.

FTA Provisions

- The results of the tariff negotiation are expressed in terms of the new Harmonized System of Tariff Nomenclature.
- All dutiable products were assigned by mutual agreement to one of the following staging categories:

immediate, five equal annual cuts (20 percent per year), and ten equal annual cuts (10 percent per year). In most instances, staging on a particular product is the same in both countries. The stages for various commodities were selected in recognition of the fact that industries in both countries will require varying periods of adjustment to changing competitive conditions.

- Import sensitive industries on both sides of the border were generally accorded 10-year staging. These include plastics, rubber, most wood products, lead, zinc, base metal articles, footwear, textiles and apparel, steel, alcoholic beverages, consumer appliances, precision instruments, watches, and most agricultural and fish products.
- Immediate duty elimination is scheduled for such products as automatic data processing and related equipment, modems, motorcycles, whiskey and rum, some processed fish, rawhides, skins and leather, furs, and telephones and telephone handsets.
- All other duties will be eliminated within five years. Included within this category are paper, furniture, printed matter, chemicals, after-market automotive parts, precious jewelry, most machines, some musical instruments, and petroleum.
- Products presently enjoying free treatment or temporary tariff-rate reductions will continue to receive such treatment.
- The agreement also provides for an acceleration clause whereby tariffs can be staged faster after the implementation of the FTA, when there is bilateral agreement.

17. Temporary Entry for Business Purposes

Bilateral Benefits: Under the FTA, qualified business persons will be able to enter either country temporarily through means of a simple and fast process at the border. Both countries will benefit from simpler procedures for the temporary entry of traders and investors, while maintaining necessary protections for indigenous workers.

Overview: Currently, professional service providers, such as architects, management consultants and engineers, have difficulties entering either country to do business. In some cases, immigration procedures are a significant barrier to trade in both goods and services. In addition, exporters

have encountered problems in entering their personnel to perform after-sales and warranty service on commercial or industrial equipment. This chapter addresses these problems.

FTA Provisions

- A list of business persons was established, including after-sales service providers, who are eligible to enter each country temporarily under simpler border crossing procedures.
- Facilitated entry for professional business persons to cross the border in order to provide their expertise or services.
- Special visa or entry procedures for certain traders and investors (those who come to sell or buy, or manage investments) to give added certainty of market access. In the United States, this is the treaty trader/treaty investor visa.
- No labor certification tests or similar procedures for temporary entry of certain intra-company transferees.

18. Wine and Distilled Spirits

Bilateral Benefits: Significant reduction of barriers to trade in wine and distilled spirits.

Overview: Retail sales of alcoholic beverages in Canada are conducted almost exclusively through provincial liquor boards or marketing agencies. U.S. suppliers of wines and distilled spirits are experiencing great difficulty marketing their products in Canada because of discriminatory provincial liquor boards, practices regarding product availability, wholesale and retail distribution, and pricing. Under the FTA, many of these barriers will be removed for U.S.-produced wine and distilled spirits.

FTA Provisions

- Tariffs on all alcoholic beverages will be eliminated over 10 years.
- Canada's discriminatory pricing system will be eliminated immediately for distilled spirits, and it will be phased out for wine. The phase out will be 25 percent of the discriminatory differential in the first year, 25 percent in the second year, and 10 percent in each of the five following years.
- Public entities selling these products will be able to charge a differential markup on wine and distilled spirits which reflects the audited difference in actual

costs of service between imported and domestic products.

- U.S. producers also will gain increased access to the distribution and marketing networks in Canada, although certain current discriminatory practices relating to distribution outlets in Canada will be "grandfathered" (allowed to continue).
- Canada will eliminate its requirement that imported bulk distilled spirits must be blended with Canadian

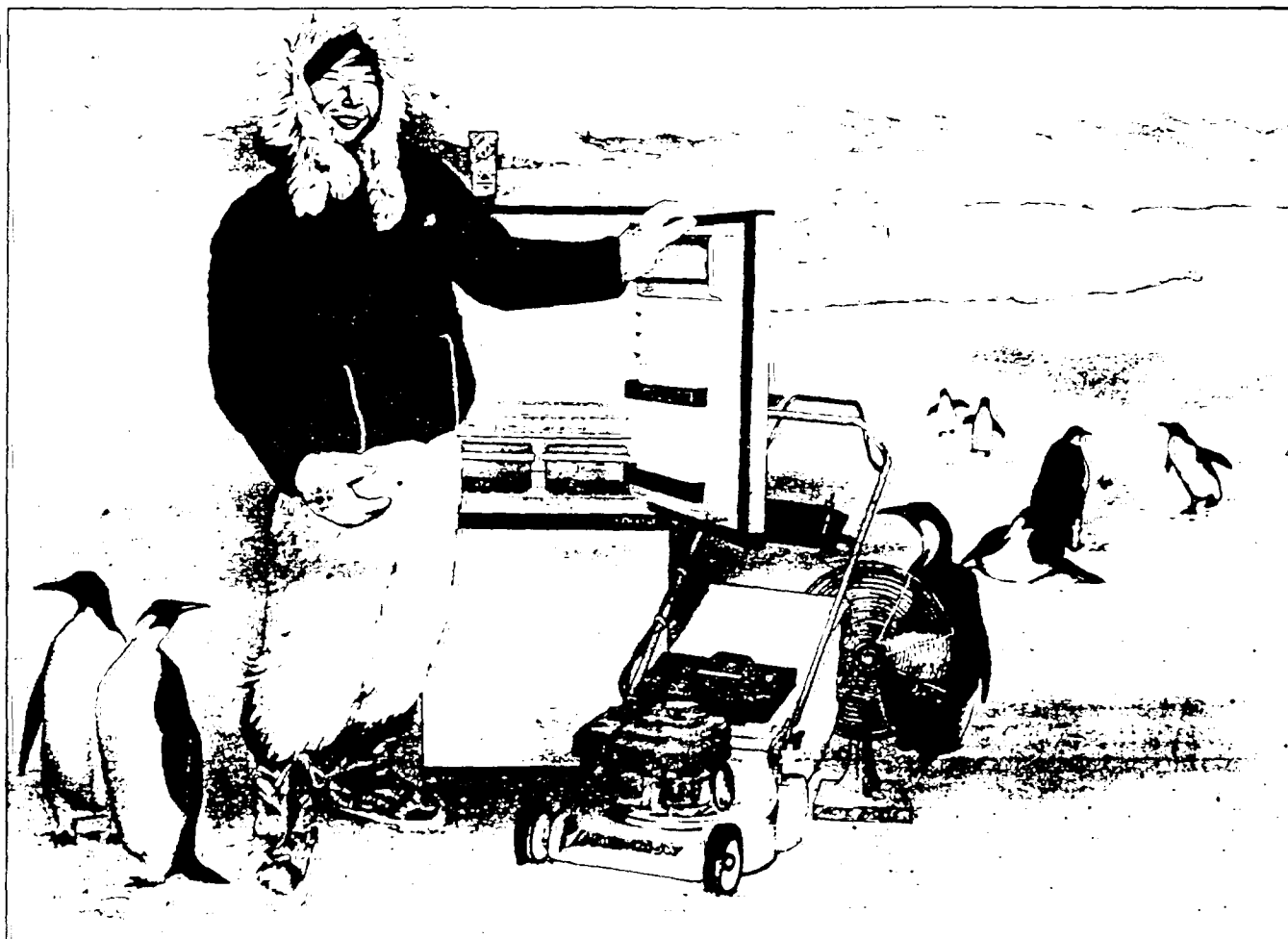
product in order to be bottled in Canada.

- Canada will recognize bourbon whiskey as a distinctive product of the United States, and the United States will continue to recognize Canadian whiskey as a distinctive product of Canada.
- Current Canadian regulations concerning beer and malt-containing beverages were grandfathered in the FTA, but the U.S. reserved its GATT rights regarding these regulations. ■

2025865395

FRANCHISE BUSINESS OF INTERNATIONAL LICENSING

BY LANNING G. BRYER



LICENSING in its simplest terms occurs where a proprietor of rights in a trademark, patent or copyright, not wishing to part completely with his intellectual property right by an outright transfer of title, authorizes the use of that right, on either an exclusive or non-exclusive basis. Generally the licensing of a trademark, patent or copyright stems from a business arrangement between two or more enterprises. Such arrangements are frequently the product of domestic or international trade.

Licensing arrangements in domestic trade can develop where the proprietor is unable, or prefers not, to manufacture the goods himself as a result of his own limited operations or a high demand. Accordingly, the proprietor authorizes a subsidiary or independent manufacturer to produce the goods under licence. Licensing in this case can be very profitable for the owner of the trademark or patent who can

grant the licence in exchange for a royalty fee from the licensee.

Franchising has also made a significant contribution in domestic trade. In the case of a contemporary franchise arrangement, a trademark or trade name is usually licensed by the owner to a licensee, who may or may not be independent of the franchisor/licensor. The licensing of the trademark or trade name permits the affiliated licensee to produce goods or perform services in commercial circles under the particular trademark, service mark or trade name.

In international trade, licensing arrangements can result from several situations. Foreign companies frequently wish to use a trademark, patent or copyright with an international reputation in order to benefit from that reputation without the investment and expense of promoting a new trademark, patent or copyright, and even the largest of companies may find it less

costly to process the goods in a foreign country by utilizing local raw materials and labour. Therefore, rather than establish their own operations abroad, these companies license an independent foreign company to use their trademark on licensed products or services. In addition, foreign concerns often wish to benefit from the know-how, technical processes and techniques of the domestic company and these trade secrets are frequently the subject of a licensing arrangement in connection with the use of trademarks or patents.

THE LICENSING REVOLUTION

MOST systems of law today provide that trademarks may be licensed with the same freedom as patents. However, prior to 1938 many countries considered the licensing of trademark rights unlawful. The passage of the Trade Marks Act of 1938 in

2025865396

the United Kingdom marked the start of the licensing revolution by which the United Kingdom and gradually other countries that follow UK trademark law affirmatively permitted the licensing of trademarks. The United States recognized licensing in the Lanham Act of 1946, but the law did not incorporate any requirement of registered user or the registration of licence agreements. Instead, the Lanham Act requires that the proprietor of the trademark control the nature and quality of the licensee's products (15 USC 1055, 1127). Section 1055 of the Lanham Act provides that "where a registered mark or a mark sought to be registered is or may be used legitimately by the lay companies, such use shall inure to the benefit of the registrant or applicant ..." and section 1127 defines a "related company" as "any person including a juristic person who legitimately controls or is controlled by a registrant or applicant for registration in respect to the nature and quality of the goods or service in connection with which the mark is used". Accordingly, the Lanham Act permits a trademark proprietor to license his trademark to anyone, provided that he retains control over the nature and quality of the goods or services in connection with the use of the trademark.

In some Civil Law countries, case law recognized the lawfulness of licensing even before 1938, while in other countries such as France (1857) and Spain (1929) the licensing of trademarks was already lawful under statute.

REQUIREMENTS

NOWADAYS most countries in the world recognize some form of trademark and patent licensing and many require recordal of licence agreements. The jurisprudence in connection with trademark and patent licensing matters is for the most part divided into two categories. The first group, British Law Countries, are those countries which follow the development of British trademark law and enactment of the "registered user" procedure defined in the UK Trade Marks Act 1938. India, Israel, Australia, Hong Kong and South Africa are among the British Law Countries which provide for registered user entries similar to s.28 of the British Trade Marks Act. If two parties are financially or otherwise related, there is generally no requirement that a trademark licence agreement be filed, but a simple registered user application can be filed, setting forth the terms and conditions of the licensing arrangement.

In the second category, Civil Law Countries, the law can vary widely as to the requirement and procedures of recording trademark, patent and copyright licence agreements. Generally, a certified copy of a licence agreement and, in some cases, an originally executed agreement, need to be submitted, whether or not the parties are related.

PROVISIONS OF THE LICENCE AGREEMENT

ONCE the idea of a licensing arrangement is agreed on by the parties concerned, a licence agreement should be drafted and executed by both parties, the licensor and licensee. Several elements at the very least should be incorporated into any licence agreement, including, but not limited to, the following:

- The grant of the licence should indicate whether it is to be exclusive or non-exclusive and, if it is exclusive, whether the licensee also prohibits the proprietor/licensor from marketing the licensed products in the territory and using the trademark or service mark.
- In the case of an exclusive licence, a provision as to whether the licensee may manufacture or sell competing products should be included. While this may be a restrictive covenant, it is often permitted if the licensee gains an advantage as a result of an exclusive licence (see Stephen P. Ladas, 'Problems of Licensing Abroad', (1966) 56 Trademark Reporter 492.)
- Provisions establishing control by the trademark or patent proprietor over the user, including
 - compliance with the standards and specifications furnished or approved by the patent or trademark owner;
 - a right of inspection of the licensee's premises, manufacturing processes and finished products; and
 - a right to receive samples of the licensed products.
- A provision as to whether a licensee has the right to assign the licence or grant a sublicense. Generally, the agreement should provide that no assignment or further licence is permitted without the prior written approval of the licensor.
- Provisions regarding termination or expiration of the licence, the option of renewal, and clauses for which licensor or licensee may cancel the agreement prior to expiration of the term. Such clauses may provide for termination based on
 - non-compliance with any or specific clauses of the agreement;

- termination with or without prior notice;
- termination in the event of the licensee's bankruptcy, insolvency or assignment of rights for the benefit of his creditors; and
- termination due to the prevention of performance that goes beyond the control of the parties (ie *force majeure* or as a result of governmental action).

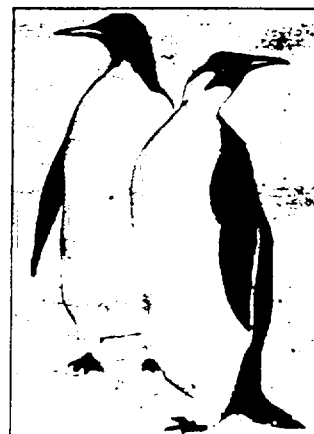
● In the event that royalty fees are included in the licence arrangement, provisions should be inserted detailing

- the time and amount of payments;
- definition of the net sales against which the royalties are to be calculated;
- an undertaking by the licensee to keep accurate and complete accounting records, as well as permitting the licensor the right of inspection.

● A clause providing that, in the case of an infringement, an action shall be at the discretion of the licensor, and that any litigation shall be under the full control of the licensor. However, an option can be included providing that the action may be brought at the sole discretion of the licensor, in the name of the licensee.

● Provisions specifying the choice of law that shall govern the interpretation and construction of the licence agreement.

The most important provisions in the agreement relate to the degree and manner of control by the intellectual property owner over the licensee in order to insure that the licensee's products or services are similar in nature and quality to those manufactured or performed by the owner so as not to confuse or mislead the public. Accordingly, it is not sufficient merely to provide for a right of inspection and receipt of samples of the licensed products as mentioned above. The trademark owner should consciously maintain an active file of inspection and verification of the licensee's products and services. ▷



2025865397

PRECISION DRAFTING

PARTIES should take care that the terms and conditions comprising the agreement between them be specifically and clearly indicated in the agreement. For example, the licensor can grant a sole or exclusive licence. The difference is that, under a sole licence, use of the intellectual property right can only be made by the licensor and licensee while, under an exclusive licence, the licensee has been given an exclusive right to use the intellectual property right, exclusive even as to the licensor unless expressly provided for otherwise. However, rather than rely on general definitions of these concepts and to eradicate any possibility of ambiguity, the licensor should state the terms specifically in the agreement as to whether or not the licensor is permitted to use the intellectual property right. This issue should not be left open to subsequent interpretation.

Furthermore, it is essential to identify clearly the intellectual property right which is the subject of the agreement as well as the nature of the goods or services that are being licensed. If possible, registration or application numbers should be utilized for identification, and specimens of relevant trademarks should be attached to the agreement as exhibits.

APPROVAL OF LICENCE AGREEMENTS

QUITE a substantial number of foreign countries will require governmental approval of licence agreements in order to record the agreement at their patent or trademark office. This requirement most frequently exists where the licensor is a foreign company, the licensee a national company, and provisions in the agreement exist providing for the remittance of royalties out of the country. Government agencies also examine the agreement for restrictive clauses or provisions that violate their local antitrust laws.

In Mexico (a Civil Law jurisdiction), for example, all technology transfer agreements are subject to approval by the Department of Technology, Development, Patents and Trademarks and they must be registered with the National Registry of Technology Transfer (NRTT). Until recently, 3% of net sales was generally considered the maximum royalty on domestic sales; now officials will allow higher rates, in some cases as high as 10%, if they feel that the technology contributes to Mexico's specific development goals (see *International Licensing & Trade, Mexico*

June 1984 13). In addition, many provisions are prohibited under Article 15 of the Mexican Law on the Control and Registration of the Transfer of Technology and Exploitation of Patents and Trademarks (effective February 11, 1982). Agreements which are unacceptable include clauses

- involving the transfer of technology freely available in Mexico;
- establishing excessively long terms (10 years is considered a maximum);
- setting a price that is out of proportion to the technology sold;
- permitting the licensor to interfere with the management of the licensee;
- requiring the licensee to keep technical information secret at the termination or expiration of the agreement and
- requiring the licensee to sell products to an exclusive client.

In Venezuela (a Civil Law jurisdiction), licence agreements must be approved by and registered with the Superintendency of Foreign Investments (SIEI) in order to be valid. Thereafter, the agreement must be recorded at the Industrial Property Office in order to prevent possible cancellation of the licensor's Venezuelan trademark registration for non-use, since use by a recorded licensee inures to the benefit of the licensor. Royalty and fee patterns vary, but a rate of 5% net sales can be considered a practical maximum. Usually, a maximum of 1% is allowed for a trademark and 4% for a patent and technical assistance (see *International Licensing and Trade, Venezuela*, March 1986 12). Decision 24 and National Decree 746 of 1975 list restrictive clauses that must be eliminated from existing agreements and may not be included in new agreements. Specifically, Venezuelan law prevents the inclusion of any clause that compels the use of specific quality controls in order to exploit the technology (Decree 746 of 1975, Article 1 (d)); prohibits the manufacture or sale of products on the basis of the licensed technology after expiration of termination of the agreement (Decree 746 of 1975, Article 1 (a)); compels the licensee to pay local taxes on the licensor's royalties and fees (Decree 746 of 1975, Article 1 (h)); and reserves for the licensor the right to determine the sale or resale prices of the licensed products used in connection with the trademark (Decree 24 of 1974, Article 20(b), 45(c)).

As a final example, in India (a British law jurisdiction), any agreement that involves remittances of royalties and fees must be reviewed by the Reserve Bank and

the Foreign Investment Board (FIB). Patent licence agreements must be recorded at the Indian Patent Office to be valid; however, the recording of a registered user agreement involving trademarks, though optional under the law, is recommended in order to insure that use by the user inures to the benefit of the proprietor. All technology transfer agreements involving a foreign party are subject to government approval. Clauses generally unacceptable in this jurisdiction include those which

- provide for payment of a minimum guaranteed royalty to licensor;
- require the domestic licensee to purchase goods, components or raw materials from one source, and
- restrict free export to foreign countries.

In addition to careful examination of agreements by governmental agencies, royalties and fees are subject to close scrutiny and the Indian government makes every attempt to keep them low.

- "For patents on food, drugs or medicine, under which compulsory licences are granted, the Patents Act set a legal maximum of 4% of sales as royalties. For other items, the general rule of thumb used by the government is that royalties, technical fees and the rest should not constitute more than 7-8% of the ex-factory sales". (*International Licensing & Trade, India*, October 1985 20).

REGISTRATION OF LICENCES

RECORDING licence agreements is frequently an essential procedure in the licensing of an intellectual property right. As already discussed above, in Mexico, recordal at the NRTT is mandatory. Failure to record the agreement will render the agreement void and unenforceable at law. Several other countries such as Peru, Colombia and the USSR, like Mexico, have strict rules of mandatory registration, while in other countries such as the Federal Republic of Germany and Switzerland, the recording of trademark licences is not possible.

At the present time, in addition to the United Kingdom, the law of most British law countries provides for the independent recording of a trademark licence agreement under the registered user procedure. The registered user procedure in many of these British law countries permits a registered user application to be filed simultaneously with a trademark application which is based on the proposed use by the user. Countries whose laws are modelled

upon Section 29(1)(b) of the UK Trademark Act 1938, provisions for simultaneous filing of Trademark and Registered User applications are as follows:

COUNTRY	TRADEMARK ACT SECTION No.
AUSTRALIA	45(1)(b)
BOPHUTHATSWANA	24(1)(b)
BRUNEI	17(b)
CANADA	39(2); 49(5), (7), (8)
CYPRUS	30(1)(b)
GUYANA	31(1)(b)
GHANA	29(1)(b)
HONG KONG	18(1)(b)
IRELAND	37(1)(b)
JAMAICA	31(1)(b)
KENYA	32(1)(b)
MALAWI	34(1)(b)
MALAYA	19(7)(b)
MALAYSIA	26(1)(b)
NEW ZEALAND	38(1)(b)
NIGERIA	35(1)(b)
PAPUA NEW GUINEA	35(1)(b)
SABAH	19(7)(b)
SARAWAK	17(b)
SEYCHELLE ISLANDS	26(1)(b)
SINGAPORE	11(7)(b)
SOUTH AFRICA	24(1)(b)
SOUTH WEST AFRICA	24(1)(b)
TANGANYIKA	32(1)(b)
TRANSKEI	24(1)(b)
TRINIDAD & TOBAGO	43(1)(b)
UGANDA	32(1)(b)
VENDA	24(1)(b)
ZAMBIA	34(1)(b)
ZIMBABWE	34(1)(b)

In addition, should the proprietor of the trademark be financially related to the user so as to own a controlling interest in the company, a trademark licence generally need not be submitted in support of the registered user application. Instead, in most circumstances, a declaration attesting to the relationship between the parties will be enough to allow the registered user to be approved and entered.

While a registered user entry can be independently obtained in the countries listed above, several British law jurisdictions, including Antigua, Belize, British Virgin Islands, Falkland Islands, Gibraltar, Granada and Montserrat, only permit entry of a registered user which has been extended from a registered user entry already obtained in the United Kingdom.

The law of many Civil Law jurisdictions also provides for the independent recording of licence agreements. In some Civil Law countries such as Japan a trademark licence may be

recorded against a pending trademark application; however, many Civil Law countries require a trademark registration to be obtained prior to the recording of the licence agreement. Submission of an original or certified copy of the licence agreement is generally required in Civil Law countries whether or not the parties are financially related.

In several Civil law and British Law countries licensing is recognized and recordation is optional but advisable for a variety of reasons. In France, for example, a licence agreement must be recorded to be effective against third parties (Article 21(2) of Decree No.65-621 of July 27, 1965). Use of a trademark by a recorded licensee protects the validity of the trademark from attack by a third party based on cancellation for non-use. In addition, a trademark licence must be recorded against each concerned trademark registration. The mere fact that a trademark registration is cited in any agreement will not be enough to obtain the protection against third parties. In Austria, Brazil and Sweden, recordation of a trademark licence is advisable to insure that use by the licensor inures to the benefit of the trademark proprietor, which in most cases is the licensor. In many jurisdictions, trademark user requirements exist which mandate that commercial use of a trademark be made within a prescribed period to avoid exposing the trademark to abandonment or cancellation for non-use. Use by a recorded licensee in many countries will satisfy the user requirement, since the licensee's use is deemed to be that of the proprietor.

MAINTENANCE OF LICENCE AGREEMENTS

SPECIFIC additional steps may be required within many jurisdictions, even once recording of the licence agreement has been completed at the respective governmental authority to preserve the registration of the licence. For example, in Mexico, annuity payments on each trademark, patent and technology transfer agreement must be paid each year, in order to prevent the registration from lapsing. Brazilian trademark practice requires that, each time a trademark is renewed, the corresponding licence must be re-recorded. In Turkey, the Certificate of Registration must be endorsed with registration of the licence each time the trademark is renewed. Accordingly, proper record-keeping procedures and practices should be instituted to insure that licence registrations remain valid and subsisting.

In general, foreign patent laws require payment of annuities during the life of the patent as well as working obligations. The requirement that a patented invention must be utilized within the country will usually be satisfied by the licensee commencing working of the patent; however, certification of such working may be required to be submitted to the Patent Office.

CONCLUSION

THE field of licensing is a highly useful and lucrative alternative to exploiting one's product, service or process oneself within the intellectual property field. It is an alternative which should be given serious consideration by practitioners, intellectual property right owners and individuals, companies or corporations seeking to develop new markets based on already well-established reputations of particular trademarks, trade names, patents or copyrights. Aside from making good commercial sense to the proprietor of the intellectual property right as evidenced by significant royalty fees, licensing can substantially improve the commercial viability of the technology involved, which in turn will increase the value of the property right. Moreover, in addition to the commercial benefits derived from licensing, consideration should be given to the legal requirements, as outlined above, in order properly and completely to protect an intellectual property right. □

2025865399



© Lanning G. Bryer 1987. The author, an associate of Ladas & Parry, New York, acknowledges the help of Ian Jay Kaufman, Melvin Simensky and Daniel F. Zendei, of Ladas & Parry, in the preparation of this article.

C. Government Affairs

2025865400

PRIMARY INDUSTRY GROUPS

Philip Morris is a member of many industry groups which play an important role in government affairs and in representing or serving the company's interests in other ways as well. The following is a brief overview of some of the major industry groups of which the company is a member.

THE TOBACCO INSTITUTE is a nonprofit, noncommercial organization founded in 1958. Its members are thirteen companies that manufacture cigarettes and other tobacco products in the United States. The aim of the Institute is to increase awareness of the historic role of tobacco and its place in the national economy and to foster public understanding of issues relating to tobacco, including taxation, environmental tobacco smoke and its role in indoor air quality, advertising, and restrictions on where and how tobacco products are sold. The Institute is a communicator of information and viewpoints on these and other matters to the public, the news media, and government at local, state, and national levels.

Policy direction is given to The Institute by a board of directors consisting of executives of its member companies. Its activities are principally conducted in its Washington, DC office by a professional staff whose members have backgrounds in government, journalism, law, education, agriculture, business, economics, and other fields. There are regional offices in major cities. The Institute has no role in competitive activities of the tobacco industry such as purchasing, manufacturing, pricing, promoting or marketing tobacco or tobacco products. Also beyond the scope of The Institute's activity is the tobacco industry's support of independent scientific research, provided principally through the Council for Tobacco Research-USA, the Center for Indoor Air Research, and direct corporate grants.

The Institute has cooperated with the National Association of State of Boards of Education to provide parental guidebooks to improve communication between parents and their children. "Helping Youth Decide" and "Helping Youth Say No" suggest means for parents to help youngsters develop decision-making skills needed

to deal wisely with everyday choices and with lifestyle decisions, such as smoking. The Institute is also a leading supporter of programs in accidental fire prevention, providing materials, funding education, and supporting prevention activities of volunteer and professional fire fighters and safety groups throughout the country.

For businesses and other organizations dealing with issues related to smoking in the workplace, The Institute provides materials and expert advice on developing policies that help employers accommodate smokers and nonsmokers alike, without resorting to unfair or discriminatory restrictions or smoking bans. The Institute also has brochures, booklets and videos available on subjects such as the contribution of tobacco to the national economy, the history and culture of the golden leaf in the nation and in 18 states in which it is grown and various aspects of smoking issues, including taxation, advertising and public smoking.

The Institute provides speakers on tobacco-related subjects for civic and service clubs, business and professional groups, college postgraduate audiences and TV and radio appearances. Generally, the age of the audience is the only restriction on where speakers will schedule appearances, in line with the industry's long standing policy that smoking is not for the young, but a custom of free choice for informed, mature persons.

THE TOBACCO MANUFACTURERS ASSOCIATION (TMA) was founded in 1915 to "foster and promote...the welfare of the tobacco industry." The TMA is a non-profit, broad-based trade association dedicated to the effective management and dissemination of objective information on the tobacco industry. Members of the TMA include tobacco products manufacturers, industry suppliers, financial institutions, leaf importers and exporters, distributors, retailers, brokers, and management consultants in the U.S. and overseas.

A major service which the TMA provides its members is economic data contained in the following TMA publications: *Cigarettes & Cigars Barometer*; *Smoking Tobacco, Chewing Tobacco and Snuff Barometer*; *Tobacco Trade Barometer-Exports & Imports*; and *Leaf*. The TMA also issues reports which put economic data in the context of legislative and regulatory proposals. Further, the TMA maintains an extensive computer database for its members' exclusive use.

2025865402

The TMA plays an important role in tracking legislative and regulatory issues such as those related to tobacco taxes, smoking restrictions, leaf marketing, packaging and labeling, advertising, sales below cost, international trade, and Tobacco Support program operations. Finally, the TMA library is the oldest, largest and most accessible tobacco library of its kind. TMA's trademark database holds over 200,000 brand names and marks and contains the most recent and the oldest trademarks on tobacco products and tobacco sundries.

* * *

THE GROCERY MANUFACTURERS OF AMERICA (GMA) is a trade association of the manufacturers and processors of food and nonfood products which are sold primarily in retail grocery stores throughout the United States. Member companies employ over 2.3 million people and have total annual sales of nearly \$280 billion. GMA's mission is to address for member companies those governmental and trade issues for which GMA group action is desirable.

The membership of GMA believes that the interests of the consuming public are best served through the maintenance and strengthening of a competitive marketplace characterized by maximum freedom of choice for consumers, appropriate regulation for the assurance of consumer health and safety, and fair returns for manufacturers and processors.

THE FOOD MARKETING INSTITUTE (FMI) was founded in 1977 and currently has approximately 1600 members from the grocery, retail, and wholesale segments of the industry. On behalf of its members, FMI maintains a liaison with government and consumers and conducts approximately 75 educational conferences and seminars per year. FMI also maintains a reference library; conducts research programs, and compiles statistics. Further, FMI issues a variety of newsletters, guidebooks, training aids, and other publications.

THE AMERICAN MEAT INSTITUTE (AMI) is the national trade association serving the meat packing and processing industry. Its primary purpose is to create a regulatory, legislative, and consumer environment in which the meat packing and

2025865403

processing industry can operate efficiently and profitably. To this end, AMI is headquartered in Washington where it acts on behalf of the meat industry's interests, provides a variety of educational programs for its members, promotes research for improved industry technology and represents the industry and its products to the public.

THE NATIONAL FOOD PROCESSORS ASSOCIATION (NFPA) is a scientifically oriented trade association which represents over 600 food processing and packaging companies and suppliers to the food industry. NFPA's primary mission is to help the food industry assure a safe, high quality food supply. NFPA's extensive food research laboratories in Washington, D.C., Dublin, California and Seattle, Washington are the foundation for virtually all the Association's activities. NFPA's technical staff of chemists, microbiologists, nutritionists, and processing and packaging experts work toward developing new processing and packaging techniques while continually refining existing practices.

THE AMERICAN FROZEN FOOD INSTITUTE (AFFI) offers a variety of services to the frozen food industry. Headquartered in Washington, D.C., AFFI maintains a strong federal government relations program and a reporting service which alerts members to legislative and regulatory developments at the state level. Other AFFI programs include technical research; public and trade regulations; distribution; publication of statistical, business and operations manuals; an annual convention; and various meetings and educational seminars.

THE NATIONAL COFFEE ASSOCIATION OF U.S.A., INC. (NCA) was founded in 1911. Today its over 200 member firms handle approximately 90% of all the coffee imported and roasted in the United States. The goals of the NCA are to: (1) promote sound business relations and mutual understanding among members of the coffee industry; (2) promote coffee consumption; (3) collect and publish information on the coffee industry; (4) work with other trade groups and governmental agencies here and abroad in matters relating to the industry; and (5) to provide member services which may lawfully help to increase the efficiency and general welfare of the coffee industry.

2025865404

* * *

THE BEER INSTITUTE is the national trade association for the American brewing industry. Formed in 1986, the Institute's members include national, regional, and local brewers and suppliers of brewing goods, services, and agricultural products. Based in Washington, DC, the Institute works closely with Congress and federal agencies on a wide spectrum of legislative and regulatory matters. The Institute coordinates member efforts on major political and social issues around the country, including taxes, trade, the environment, and farm policy.

The Institute also works with state and local regulators and legislators to draft local policy on issues ranging from liability insurance to sales taxes. In communities nationwide, Institute-supported safety and moderation campaigns are implemented in conjunction with individual brewer efforts. This partnership is closely linked with civic and charitable group programs to fight alcohol abuse and to promote safety and moderation.

From tax policy to public safety, the Institute speaks on behalf of America's 80 million beer drinkers. Together with its member companies, it seeks to preserve the American brewing industry's reputation for the highest levels of product quality and civic leadership.

2025865405

LEGISLATIVE HIGHLIGHTS

Set forth below is a brief overview of federal legislative issues of particular concern to the tobacco, food, and brewing industries.

Tobacco Industry

Excise Taxes Proposals to increase the cigarette excise tax will be a topic in every forum in which the budget deficit is discussed. In addition, rifle shot attempts to use the tax to pay for a range of specific projects, such as health care and low-cost housing, have become commonplace.

Advertising Hearings on serious proposals to prohibit or further limit the advertising and promotion of tobacco products can be expected in one or more Energy and Commerce Committee subcommittees in the House. Parallel efforts to remove the business tax deduction for advertising and promotion costs will be before the House Ways and Means and Senate Finance Committees.

Labeling The 1988 Surgeon General's Report on Smoking and Health focused on the issue of addiction. Legislation to require an addiction warning label on cigarette packages and advertising is certain to be introduced in Congress this year. Introduction of such legislation is also likely to raise the question of repealing the current preemption provisions contained in the Cigarette Labeling and Advertising Act.

Airline Smoking The sponsor of the smoking ban on two-hour domestic flights has announced his intention to use the appropriations process to extend this ban to all domestic flights in 1989, even though the two-year trial period on the two-hour ban will not expire until 1990.

2025865406

Military Sales Measures to raise cigarette prices in military sales facilities, or to remove them from commissaries altogether, will be offered, particularly in the Senate. These efforts ignore the fact that lower prices for all products in exchanges and commissaries are considered part of the military benefits package.

Fire-Safe Cigarettes An inter-agency committee, created by Congress, has concluded that it may be possible to manufacture cigarettes which are less likely to set fires and has recommended additional study to establish, for example, a "validated test method". The tobacco industry supports legislation introduced last year which would implement these recommendations. Other legislation may be introduced which would ignore the committee's recommendations and proceed directly to implementation of a standard.

Food Industry

Food Labeling Reform A number of important federal and state proposals relate to food labeling requirements. Taken together, these proposals raise the issue of whether there should be a broad requirement of national uniformity in food labeling. Increased state regulation of products that are advertised and marketed on a national basis and aggressive enforcement activities by state attorneys general have encouraged the company to participate in a variety of efforts to obtain pre-emption of state regulations through federal legislation, federal regulation, and litigation.

Specific labeling issues worthy of note include the following:

Proposals to require nutrition labeling for all foods when (a) a health claim is made; or (b) the product is fortified; or (c) when the product exceeds specified fat and caloric density "triggers." The alternative to these types of proposals is a continuation of the present voluntary standards;

Proposals to require labeling of both cholesterol and fatty acid content of foods about which a claim is made. These proposals require a determination of what specific fat/cholesterol content should "trigger" such labeling; and

Proposals to require additional country of origin labeling for many food products, including meat. These requirements could apply even to products which are subject to substantial domestic processing and transformation. Compliance with country of origin labeling regulations would be costly and would reduce flexibility in product formulation.

"Revenue Enhancers" There is a possibility that increased fees could be charged to processors to cover such items as federal meat and poultry inspections and "value" of port use by goods which are imported or exported.

Temporary Emergency Food Assistance Program In recent years, the federal government has disposed of excess cheese by giveaways. These programs are likely to reduce cheese sales.

Farm Legislation (Dairy Price Supports) Congress will begin consideration of new farm legislation in 1989 because current legislation will expire in 1990. In general, the company has an interest in assured sources of dairy supplies, lower dairy prices, and reduced dairy stockpiles. At times, however, it is difficult to reconcile these conflicting goals.

Farm Legislation (Milk Marketing Orders) In essence, these regulations raise the price of raw materials purchased by the company. Nevertheless, the company does not believe that it would be in its best interest to oppose milk marketing orders generally and the company often participates in the regulatory proceedings that produce these regulations.

Farm Legislation (Sugar Price Supports) Efforts to reduce sugar price supports and increase foreign producer quotas would lead to lower sugar prices. These efforts include opposition to higher loan rates to producers.

Tamper Resistant Packaging An important consideration in the food industry is the use of tamper resistant packaging. Proposals are made from time to time to regulate this packaging feature. In addition, product liability doctrines may constitute a form of indirect regulation. The company generally believes that tamper resistant packaging should not be dictated by regulation but should instead be determined by competitive forces.

2025865408

Brewing Industry

Taxation A number of proposals to increase the federal excise tax on alcohol beverages will be considered in 1989. Among those proposals are:

A straight increase across the board;

Equalizing the excise tax rate on beer and wine to that on distilled spirits;

Adjusting the excise tax rate to reflect changes in the Consumer Price Index; *and*

Increasing the excise tax while earmarking the revenues to fund the Omnibus Drug Bill.

Advertising/Marketing Restrictions Federal legislation now requires warning labels on alcohol beverage containers. It appears that the next step -- restrictions on alcohol beverage advertising -- will soon be considered. As a result of the Surgeon General's Workshop on Drunk Driving, a number of the recommendations on advertising restrictions which the Workshop proposed will probably be introduced as legislation. The recommendations include elimination of alcohol beverage advertising, elimination of tax deductions on alcohol beverage advertising, and a requirement that the warning label now required on containers also appear on all alcohol advertising.

2025865409

D. Product Liability/Recall

2025865410

Tobacco Litigation: *Cipollone* and Its Progeny

BY ANDREW BLUM
National Law Journal Staff Reporter

SIX MONTHS after the first product liability verdict against a tobacco company, the number of actual cases on file seems to favor the industry. But plaintiffs' attorneys insist there are more on the horizon and they will eventually win the multimillion-dollar David and Goliath battle.

Was the \$400,000 verdict in the *Cipollone* case truly a milestone plaintiffs' victory? Or was it a tobacco win and a signal that suing tobacco companies doesn't pay? (NLJ, June 27.)

The case is currently under appeal in the 3d U.S. Circuit Court of Appeals by the one losing defendant, Liggett Group Inc., and there are signs the plaintiffs' widower, Antonio Cipollone, is tiring of the litigation. *Cipollone v. Liggett Group Inc.*, 83-2864 (D. N.J.).

The defense said the message is

clearly that the suits are too costly and time-consuming for plaintiffs to pursue. But when it comes to actual numbers, plaintiffs' attorneys differ on whether the June 13 verdict is opening litigation "floodgates."

Some lawyers admit it may be the mid-1990s before the verdict is really in and agree with industry statistics of 83 pending suits as of Dec. 14 versus 151 in May 1987. But others, like Paul M. Monzone of San Francisco's Law Offices of Melvin M. Belli Sr., said there are between 1,000 and 1,500 actual or potential cases around the country.

Spokesmen for Philip Morris, which is named in 38 of the pending cases, called the 1,000-to-1,500 figure "preposterous" because there have only been 300 cases total filed in 30 years of tobacco litigation.

Mr. Monzone said he obtained his estimate after conferring with colleagues, but could not specify the filings since the *Cipollone* verdict. "The

tobacco industry may not be completely aware of some [of the cases]," said Mr. Monzone. "We have been deluged by potential cases since *Cipollone*."

But the industry sticks to its records, maintaining that since the verdict, 16 cases were dismissed or dropped and only two new cases were filed.

"It reflects what we said that despite the fact that there was a verdict for the plaintiffs, clearly it was a victory for the tobacco industry," said Robert Northip of Kansas City, Mo.'s Shook, Hardy & Bacon, whose firm represents Philip Morris and Lorillard Inc.

Mr. Northip, whose clients were not found liable for the injury to Ms. Cipollone, said a key to the industry view is that the jury failed to find fraud and misrepresentation as the plaintiffs — who introduced reams of company documents — had alleged. The jury found Ms. Cipollone 80 percent responsible for her actions but said Liggett was partially liable.

"It looks to me as though the events since the case justify our point of view," he said, adding if plaintiffs' predictions were true, "you would have seen a lot more cases."

Richard A. Daynard, chairman of the Boston-based Tobacco Products Liability Project, compared the current litigation to a barbecue with coals simmering. "Eventually it will catch fire."

"Maybe I was naive to think it would have happened sooner," he said. "But we're close," he said, citing *Cipollone* and a 1988 mistrial in a Mississippi case, *Horton v. The American Tobacco Co.*, 9050 (Cir. Ct., Holmes Cty.).

Cynthia Walters, who tried the plaintiffs' case with co-counsel Marc Z. Edell and Alan Darnell, said they never predicted a floodgate and are optimistic more wins will come, partially through use of *Cipollone* documents.

"Cases will continue to be filed in a slow arduous process until we have a record of people winning," said Ms. Walters of Short Hills, N.J.'s Budd Lerner Gross Picillo Rosenbaum Greenberg & Sade P.C.

Perhaps one overlooked point, she indicated, is that the *Cipollone* documents were only those of three defendants and there are not yet any public documents from R.J. Reynolds Tobacco Co. and Brown & Williamson Tobacco Corp.

"We are in discovery against both and have some documents but they are not public due to confidentiality orders," Ms. Walters said. In New Jersey, the industry continues dragging cases out and is "putting off the inevitable" because whether plaintiffs win or lose, those companies' documents become public, she said.

Mr. Daynard, in a recent TPLP newsletter, observed that the current wave of tobacco conglomerate financial activity — the Philip Morris-Kraft Inc. merger and R.J. Nabisco's leveraged buyout — comes during a litigation lull.

R.J. Reynolds is a co-defendant in a pending case with the *Cipollone* defendants, which Ms. Walters said is "in good shape." Shook Hardy's Mr. Northip said it is stayed pending determination of issues in the *Cipollone* appeal. *Haines v. Liggett Group Inc.*, 84-678 (D. N.J.).

Ms. Walters hopes to win the appeal and avoid a retrial. "Mr. Cipollone is not thrilled about the idea of trying the case because he sat through 4½ months of trial," she said. "It was a difficult experience for him. That does not mean he won't do it."

For her work on the case, Ms. Walters and co-counsel shared an award for trial lawyer of the year last summer from the Trial Lawyers for Public Justice, a Washington, D.C., public interest law firm.

In the aftermath of the case's publicity, TLPJ Executive Director Arthur H. Bryant said tobacco cases are going well, with several moving to trial. He added that *Cipollone* documents likely will help elsewhere and the Minnesota Supreme Court could soon rule on preemption. *Forster v. R.J. Reynolds Tobacco Co.*, C1-87-2170.

The industry claim that cases are not worth plaintiffs' efforts, said Mr. Bryant, amounts to "trying to scare lawyers out of taking these cases ... when they know full well there are cases that are slowly coming along that are likely to prove the opposite."

That view was not shared by product liability expert Victor E. Schwartz of Washington, D.C.'s Crowell & Mooring, who sees a gradual end to litigation and a possible reversal in *Cipollone*.

"Courts and jurors are saying 'We're not going to make an award simply because there is a rich defendant,'" he said. "This means five years from now we will look back and see this as just a blip on the product liability horizon."

2025865411

Product liability movement may really be weaker after *Cipollone*

By Roy A. Burry

The extremely strong industry fundamentals providing tobacco companies with strong profit comparisons have become increasingly visible throughout the 1987-88 period. These include:

- extremely favorable rates of price improvement, widening domestic profit margins;
- growing worldwide cigarette demand in combination with excellent market share expansion throughout the world;
- accelerating excess tobacco cash flow resulting from rising domestic profitability and declining capital expenditures supporting cigarette manufacturing facilities; and
- a large portion of total earnings generated by domestic operations, in turn permitting major benefits from lower 1987-88 tax rates.

Profit progress acceleration stemming from the above factors is permitting major investment in both non-U.S. tobacco and non-tobacco businesses. In addition, worldwide consumption and the market shares of certain companies may benefit significantly from a new cigarette product to be introduced before the end of 1988.

Rather than attempting to predict the outcomes of individual suits based upon hard-to-assess trial events, we have provided an overall framework for analysis of the tobacco litigation issue.

The conclusion derived from

this analytical framework is that the long-term impact upon the earnings performance and financial condition of the industry will be negligible, and to date no court decision falls outside this logic.

The three principal elements of this argument, discussed in detail in the February 22 issue, are briefly summarized below.

I. The plaintiff's difficulty in winning. The following indicate that tobacco companies will experience very few, if any, serious losses throughout the ongoing period of litigation.

1. Unlimited resources permit the industry to assemble top legal counsel, with vast tobacco liability experience. The plaintiff's counsel, however, typically has not had the benefit of prior experience and invariably is working under uncertain conditions permitting payment of sizable fees only in the event of substantial awards.

In addition to this "unevenness" of legal representation, other factors tip the legal scale in the defendant's favor. First, the adequacy of the warning label required by Congress beginning in 1966 has been tested at the appellate level of the Federal court system and has been consistently ruled preemptive and therefore adequate. Second, it is

Roy A. Burry is a vice president at Kidder Peabody & Co. and its tobacco industry analyst.

extremely difficult to prove a causal relationship medically between cigarette smoking and those maladies most often associated with tobacco usage. Third, the "freedom of choice" and "burden of responsibility" arguments used by defense attorneys have proven to be persuasive.

II. The first adverse decision. Whether the recent decision in the New Jersey *Cipollone* case represents a victory for the plaintiff or defendants is debatable. However, the following factors indicate that investor fears of financial disaster stemming from the industry's first adverse decision are unwarranted.

- Decisions in jury trials do not alter product liability jurisprudence. Although a successful plaintiff argument may indeed draw duplications from other attorneys, common law is not changed through jury trial.

- Class action suits against the tobacco industry are not possible given the lack of commonality and uniqueness associated with those maladies typically associated with cigarette smoking. Thus, each plaintiff must continue to file suit individually under the same product liability law in existence for many years.

- In every case to date, the defendant(s) has been held free of punitive damages, without which the magnitude of any settlement would remain insignificant.

2025865412

(Cont.)

cant.

• A growing number of states are passing legislation designed to limit massive jury awards in product liability cases. Because of the high court cost associated with the filing of usually fruitless suits against tobacco companies, these statutes virtually eliminate the possibility of similar suits.

III. Price flexibility. Even assuming virtually impossible worst case scenarios concerning both the number of product liability suits lost by the industry and the magnitude of awards presented, relatively small cigarette price increases would offset the entire cost to the industry. Almost any cost associated with product liability litigation, no matter how draconian, could be easily offset in view of the revenue magnitude and price flexibility of the tobacco industry.

What happened in the Cipollone case?

For the first time ever, a jury awarded relief to a plaintiff seeking damage from cigarette smoking. On the basis that Liggett's pre-1986 advertising created an expressed warranty contract between it and the consumer that cigarette smoking was not a potential health hazard, the company was ruled in violation of this contract.

The jury also ruled that (1) cigarette smoking was a "proximate" cause of the plaintiff's death and (2) prior to the 1966 imposition of cigarette warning labels, the company should have warned of the potential health hazards of cigarette smoking. However, no award was made on this basis because the consumer was ruled to have been mostly responsible for her own actions.

The charges of conspiracy and fraud were rejected by the jury.

Ample opportunity exists for both sides of this case to claim at least a partial victory.

Conspiracy and fraud denied.

Massive documents researched extensively by the plaintiff's attorneys proved fruitless in establishing conspiracy and/or fraud on the part of the cigarette producers. Examined at great cost,

these documents failed to establish the plaintiff's contention that the industry was aware of health hazards associated with cigarette smoking and conspired to withhold information and/or mislead the public in this regard. Thus, future plaintiffs, and more important, their attorneys, are discouraged from projecting damages significantly greater than relatively small "sympathy" awards based principally upon ordinary damages. Rejection of the plaintiff's argument in this regard reinforce our contention concerning the extreme difficulty of future plaintiffs to achieve the potentially larger punitive damages.

Small damages. The attorneys' share of the small \$400,000 awarded the plaintiff falls far short of break-even level. Total plaintiff costs to date are believed to have been \$2-to-\$3 million, and expenses during the appeal process have yet to be incurred. Even if substantially lower costs are experienced by future plaintiff law firms operating on contingency, any revenue received, as indicated by the award in the *Cipollone* case may not offset costs. Virtually all suits filed against tobacco companies are initiated by legal firms hoping to obtain a portion (usually one-third) of a massive award. This case, therefore, could discourage the initiation of major future investments of this nature by the legal profession.

Potential reversal on appeal. Violation of express warranty, the only basis upon which the jury awarded damages, is not a unique argument and has been rejected by the court in all prior cases. This tends to support the industry's contention that the jury in the *Cipollone* case was "erroneously" charged by a "hostile" judge with regard to expressed warranty contract law, and therefore Liggett has a high probability of reversal of the decision upon appeal. If the company prevails in this regard, such a reversal would virtually close the door on future arguments of violation of expressed warranty.

Liggett's appeal will be filed

during the 30-day period following the June 27, 1988, hearing of final motions by Judge Sarokin, with the earliest possible date for decision at the appeal level being around year end. The primary basis for this appeal is likely to be Judge Sarokin's failure to instruct the jury that Rose Cipollone must have relied on the pre-1986 Liggett advertising as required under express warranty jurisprudence. This appeal to the third circuit in Philadelphia will be one of the most closely watched tobacco actions to date.

What might the industry have lost?

Under pressure from adverse decisions to the plaintiff and increasingly restrictive state laws, the number of active suits pending against tobacco companies has declined significantly in recent months, reaching about 100 before the *Cipollone* decision. Its limited magnitude notwithstanding, the damages awarded the plaintiff in the *Cipollone* case represent the first payment ever made by a cigarette producer. It is uncertain at this time whether this highly publicized decision will result in a reversal of the downward movement in filings. This number is closely tracked by industry sources and must be watched carefully in coming months.

The *Cipollone* case indeed did represent a unique decision with regard to the following two factors.

1. A jury for the first time found that cigarette smoking was a "proximate cause" of the plaintiff's illness.

2. The jury ruled that the defendant should have warned the plaintiff of potential health hazards associated with cigarette smoking prior to the 1966 imposition of warning labels.

If juries in the many states which operate under different product liability laws than New Jersey can be convinced of both these facts, small awards might be possible even if the plaintiff was found to be mostly responsible for his or her cigarette smoking and health problems.

Violation of expressed warranty

remains a key part of product liability law. The decision by the jury to award damages based upon this contract violation could encourage similar arguments by plaintiffs' attorneys in the future. This possibility, of course, hinges, to a large extent, upon the authenticity of the defendant's contention that Judge Sarokin's charge of the *Cipollone* jury both differs from past charges and was erroneous.

The jury in the *Girton versus American Tobacco* case was decided on the basis that the defendant's failure to warn prior to 1966 did not contribute to the plaintiff's health problems, and it ruled entirely against the plaintiff. Earlier, the judge had ruled that the express warranty argument was not valid and prevented its use by the plaintiff.

Our conclusion. In each tobacco liability suit that reaches the trial stage, the plaintiff's arguments and the outcome may differ at least partially from preceding cases. Nothing in the *Cipollone* decision, however, falls outside our analytical framework established some time ago and already summarized in this report. Our evaluation of both the nature of this decision and possible results on appeal (and the *Girton* case) indicate a further ebbing of the product liability issue. There is little or nothing in recent case results indicating a significant long-term risk to the financial position or performance of the tobacco industry. In fact, just the opposite is true.

This conclusion notwithstanding, there is little in the *Cipollone* decision offering investors the immediate possibility of a major surge in stock valuations from current depressed levels. Some gradual upward revaluation seems possible as always-negative media attention becomes less intense, and stock prices should be buoyed by anticipated and realized strong profit and dividend progress. Nevertheless, the tobacco group will remain volatile in price and responsive to highly publicized events which have as a common source the nature of the product.

2025865413

Business Day

The New York Times

SATURDAY, SEPTEMBER 10, 1988

Surprise Tobacco Data: Suits Fall

The Flood Expected After Jersey Verdict Doesn't Materialize

By WILLIAM GLABERSON

Three months after the first jury verdict ever against a tobacco company for a smoker's death, the flood of lawsuits that antismoking advocates predicted would threaten the cigarette industry's future has not materialized; new statistics show.

The surprising new data are the strongest evidence to date that the tobacco industry's strategy of wearing down and outlasting its opponents with an aggressive, expensive defense may be working.

Since June 13, when a New Jersey jury won national attention with its award of \$400,000 to Antonio Cipollone, the widower of Rose Cipollone, who had been a cigarette smoker, lawyers have filed only one new suit against a tobacco company and have withdrawn 11 others. Of those dropped, no settlements were reached. The number of pending suits is now 85, down from 152 in March 1987, when the wave of tobacco cases reached its zenith, according to data compiled by the industry's committee of lawyers in response to a request by The New York Times. Antismoking advocates do not quarrel with the statistics.

Successes in Other Cases

People on both sides of the contro-

versy say the number of antismoking suits has declined because of a string of tobacco industry successes in other cases.

Lawyers for smokers and their survivors may also be discouraged, legal experts say, because the Cipollone verdict was not as clear a success as the antismoking forces had hoped. The jury gave what lawyers said was a relatively modest award to Antonio Cipollone, but it gave nothing to the estate of his wife, who the jury said was 80 percent responsible for her death by continuing to smoke after concerns about tobacco and health had become widespread. The case is believed to have cost Mr. Cipollone's lawyers at least \$500,000 to prepare.

"The plaintiffs' bar has begun to recognize the hurdles in these cases, including the issue of the personal responsibility of the smokers themselves," said Marshall S. Shapo, an expert on product-liability law at Northwestern University.

On Wall Street, some analysts are saying that investor concerns about the potential impact of the liability cases on the financial health of the tobacco companies are beginning to ease. As evidence, they note that the stock prices of the two major cigarette makers, Philip Morris and RJR Nabisco have been gradually increasing in recent months.

Investors have been wary of tobacco stocks since mid-1985, when the lawsuits first drew national publicity. Antismoking advocates had suggested that a single victory could jeopardize the industry's financial

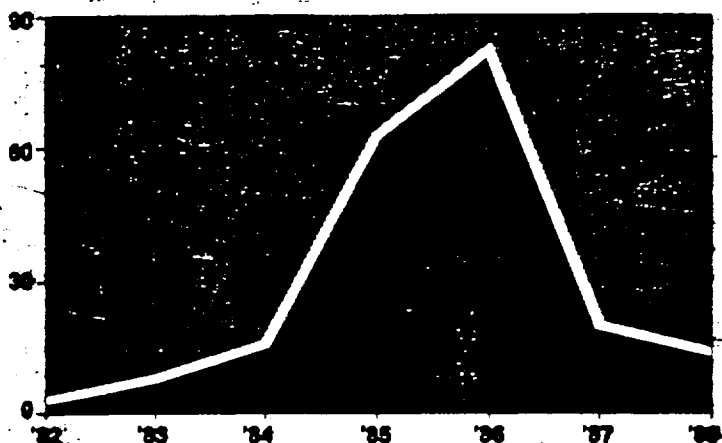
2025865414

SEP 12 1988

Cesar A

Attacks on Tobacco Companies Ease

After peaking in 1986, the number of new suits filed annually in the United States against tobacco companies involving smokers' deaths has fallen sharply, shown below. The number of cases pending has also dropped, from a high of 152 in 1987 to 85 this year.



Source: Committee of tobacco industry counsel

The New York Times/Sept. 10, 1988

base by encouraging hundreds if not thousands of suits by survivors of the estimated 300,000 people whose deaths are linked to smoking every year.

Higher Prices Hoped For

Besides hoping that the industry would have to pay big awards, antismoking advocates also hoped that the litigation would force the industry to raise prices, which might discourage people from smoking.

"We are in the final throes of lifting the litigation cloud from the cigarette industry," said Emanuel Goldman, a tobacco analyst at Paine Webber Inc.

While some legal experts last June had hailed the Cipollone verdict as a victory for the tobacco industry, some in the antismoking camp had predicted that it would be "the case" that would "open the floodgates of litigation."

"There will be cases from Anchorage, Alaska, down to Miami," Melvin Belli, the well-known plaintiff's lawyer, told Newsday on the day of the verdict.

But in light of the new data and the industry's court record, some antismoking advocates are now more pessimistic. The battle with the industry "is going to take longer than I had ever imagined," said Richard A. Daynard, chairman of the Tobacco Products Liability Project at the Northeastern University School of Law and a leader of the antismoking drive.

Industry Victories

The industry has won four important Federal appeals court decisions on major legal issues. In these cases, the appeals courts agreed with the industry argument that smokers cannot sue companies for failing to warn them about the health risks of smoking.



Associated Press

Antonio Cipollone, after jury awarded him \$400,000 in suit against tobacco companies in the death of his wife, Rose.

ing after Congress mandated warnings on cigarette packages in 1966. Antismoking advocates have succeeded only in a Minnesota appeals court. In addition, the industry won several trials before and one since the Cipollone verdict.

Some lawyers who backed out of litigation were not prepared for the tough battle waged by the tobacco companies on every case, antismoking activists say.

"There are a lot of lawyers who said: 'Hey, this is an easy win,'" said John F. Banzhaf 3d, executive director of Action on Smoking and Health, an antismoking group. "They jumped in and they filed all these cases and

then they found out how tough they were so they dropped them."

Delaying Tactics Charged

Tobacco lawyers make extensive demands on smokers' lawyers' time and employ what those lawyers charge are skillful delaying tactics.

In a memo at one of R.J. Reynolds's law firms this spring a lawyer told his colleagues that an opponent was dropping 10 cases against Reynolds because "the aggressive posture we have taken regarding depositions and discovery make these cases extremely burdensome and expensive for plaintiffs' lawyers, particularly sole practitioners."

Daniel W. Donahue, a partner in the law firm of Womble, Carlyle, Sandridge & Rice in Winston-Salem, N.C., confirmed that the memo had been written by one of the firm's lawyers but said it did not represent the official defense posture of Reynolds.

Analysts say the latest turn in the tobacco litigation does not mean it is coming to an end. But what might have been a disabling onslaught for the cigarette industry is becoming instead a nagging fact of business life that is likely to remain for years. "What we're beginning to see is that the legal issue is more of an irritation than something that is going to put them in financial jeopardy," said George E. Thompson, a securities analyst at Prudential-Bache Securities.

Lawyers who may already be reluctant to take on the tobacco industry got an additional dose of caution in an article in the current issue of *The American Lawyer*. The trade newspaper reports that interviews with jurors in the Cipollone case indicated that the industry's lawyers were very convincing. At least one juror who reluctantly supported a compromise to award Mr. Cipollone the \$400,000 has changed her mind, and wishes she had held out, the newspaper says. That would have resulted in a hung jury.

According to a Knight-Ridder News Service report on Sept. 4, three of the six jurors now say they should not have awarded any money. Both sides are expected to appeal the verdict but jurors' afterthoughts would not be considered by appeals judges.

Given the many turns in the more than 300 liability cases over 25 years, industry representatives are not declaring victory. But that does not stop them from trying to get as much mileage as they can from the current good news.

"Certainly a lot of people predicted that Cipollone would open the floodgates," said Thomas D. Ricke, the chief spokesman for Philip Morris. "We didn't think so. We were told we'd have to wait and see. Well, we've waited and we've seen."

2025865415

Market Place

Robert J. Cole

Alcohol Lawsuits And Stock Impact

THE slow accumulation of lawsuits against producers of alcoholic beverages, blaming their products for various injuries, has caused at least one analyst who follows the industry to reconsider his investment outlook. Early this month, Noel Sloan, who follows brewers for Kleinwort Greaveson Securities in London, switched his advice to clients regarding the Anheuser-Busch Companies from "buy" to "reduce holdings."

"Claims against alcohol companies now raise the possibility that the beer industry could face a series of product liability claims similar to those faced by the cigarette industry," Mr. Sloan said.

Mr. Sloan said that he was struck by a Pennsylvania case against privately held Stroh Brewery Company, which contends that relatively moderate consumption of Stroh's Old Milwaukee — two or three cans on four nights a week over a six-year period — had caused the death from acute pancreatitis of William Hon, a 20-year-old carpenter from Wilkes-Barre, Pa. Previous claims have involved far heavier consumption.

In addition, Mr. Sloan noted, there are several suits in Seattle blaming various alcoholic drinks for birth defects. The defendants in these "fetal alcohol syndrome" suits include Anheuser-Busch; Potter Distilleries; the Brown-Forman Corporation; the James B. Beam Distilling Company, a unit of American Brands Inc.; Heublein Inc., a unit of Grand Metropolitan P.L.C.; the G. Heileman Brewing Company, the Joseph Schlitz Brewing Company, a unit of Stroh; and the Olympia Brewing Company, a unit of the Pabst Brewing Compa-

ny, which is owned by the S&P Company.

All of the suits maintain that the children suffered from such conditions as mental retardation, problems of the central nervous system, heart and limb defects and malformed faces, because their mother's drank during pregnancy. The parents, represented by Barry M. Epstein, a Newark lawyer, do not say how much alcohol the mothers consumed but seek damages for past and future care.

Mr. Sloan said that the health problems associated with alcohol were far less common than those stemming from smoking. He noted, however, that alcoholic beverages do not carry warning labels, which have turned out to be an important defense in the cigarette litigation. He is also concerned that damage to unborn children stirs strong emotional responses that could attract bad publicity and result in a wave of new complaints.

The important point, Mr. Sloan maintained, is that cigarette stocks have already been discounted for the litigation problems. They stand at about a 30 percent discount to the market. Anheuser-Busch and other alcohol producers are not yet discounted for litigation worries and thus present a greater downside risk, he said.

"Clearly plaintiffs have major obstacles to overcome before winning a case against alcohol companies, as they did with the cigarette industry," Mr. Sloan said. "Nonetheless, when Wall Street focuses on this issue over the coming weeks and months the effect on sentiment — and share prices — could be dramatic."

Anheuser-Busch has drifted down from \$31.25 a share to \$29.375 on the New York Stock Exchange since Mr. Sloan's recommendation, but most of his colleagues say his fears are unwarranted.

"Alcohol litigation is not quite comparable to the tobacco suits because you have all these statistical correlations, healthwise," said Emanuel Goldman, the beverage analyst for Paine Webber Inc. "If you

don't abuse alcohol, nothing's going to happen to you."

Mr. Goldman could not disagree more with Mr. Sloan about Anheuser-Busch, which he believes clients should be aggressively accumulating. "It's in a class by itself," Mr. Goldman said. "Its position in the industry is unequaled."

And Joseph C. Frazzano, who tracks beverage stocks for Oppenheimer & Company, said: "It's highly unlikely anything will come of this. I don't see anything like the tobacco industry." Mr. Frazzano has both Anheuser-Busch and Brown-Forman on his recommended list.

"I haven't examined the suits, but my sense is that these cases have no basis or foundation whatsoever," said Martin Romm, who follows the industry for the First Boston Corporation.

Stephen K. Lambright, vice president of Anheuser-Busch, argued that the Kleinwort analyst had "greatly exaggerated the impact" of the lawsuits. The company said that every case involving alcohol abuse to date had eventually been dismissed and that it does not expect to see many suits in the future.

Alcohol producers dismiss the concern over the lack of a warning on their product. Some argue that women are warned by their doctors not to drink or smoke during pregnancy. Nevertheless, the demand for warnings is spreading along with the litigation.

Starting next October, alcohol companies operating in California will be required to use signs at point of sale warning of birth defects during pregnancy. Such signs are already required in New York City, parts of California and elsewhere. Warning labels are also proposed in Federal legislation by Senator Strom Thurmond, Republican of South Carolina, and Representative John Conyers Jr., Democrat of Michigan.

202585516

Must Drinkers Be Warned of Risks?

Alcohol Marketing Under Attack

BY ANDREW BLUM

National Law Journal Staff Reporter

SEVERAL LAWSUITS around the country are mounting new challenges to the alcoholic beverage industry's marketing tactics, and contend it has to warn consumers about the possible dangers of drinking.

Beer and liquor manufacturers have faced sporadic product liability suits in the past, but have thus far escaped liability because courts, in dismissing charges against them, have said the harm from alcohol is so obvious there is no need to warn.

"If the risks are as obvious as warts on a debutante's nose, many defendants say there is no duty," said Thomas F. Lambert Jr., a professor at Suffolk University Law School in Boston. Professor Lambert said the area has been "well-thrashed" but now plaintiffs' attorneys are

using more "subtleties and sophistication."

One arguably sophisticated case was brought by the family of a Pennsylvania man whose "moderate" beer drinking allegedly damaged his pancreas and killed him. The case was dismissed in federal district court but the 3d U.S. Circuit Court of Appeals overruled the lower court late last year, saying a jury should have the right to consider the issue of liability for failure to warn about risks of moderate drinking. *Hon v. Stroh Brewery Co.*, 835 F.2d 510.

The plaintiffs' attorney, Maurice A. Cardone of Wilkes-Barre, Pa.'s Toucy & Namey, noted that the 26-year-old plaintiff drank three to four Old Milwaukee beers three to four nights a week for 5½ years — a total of 3,000 beers. Mr. Cardone said that may seem like a lot of drinking at first blush, but he added it was "not more than [that consumed] by the average person."

Continued on page 10

Defendants say risks of drinking are 'as obvious as warts on a debutante's nose,' according to one law professor. But, he adds, plaintiffs' attorneys are now using more 'subtleties and sophistication.'

Attorneys for Stroh, in the brewery's motion for summary judgment, told the lower court that it cannot be held liable because its beer — Old Milwaukee — was not defective and it was under no duty to warn of the obvious dangers connected with alcohol.

Product liability attorney Victor E. Schwartz of Washington, D.C.'s Crowell & Moring said the case presented an unusual question because the plaintiff's condition occurs in perhaps one in 100,000 people.

Asserting that liquor has certain inherent, immutable characteristics — just as "knives cut and gas burns" — Mr. Schwartz said the jury would have to jump several hurdles to find against Stroh. Even if the plaintiffs could prove there is a duty to warn, the jurors would still have to consider whether the man would have consumed the beer regardless of any warning.

Sheila L. Birnbaum of New York's Skadden, Arps, Slate, Meagher & Flom, Anheuser-Busch Inc.'s national product liability counsel, said the company's defense has been to say that the

holic beverage manufacturers, she added, all have been unsuccessful.

"They have argued — in many jurisdictions — alcoholism, addiction and hyping by ads," Ms. Birnbaum said. "And in all of the cases the courts have uniformly dismissed these cases. She noted that *Hon* is the only product liability case not to have been dismissed so far.

Fetal Alcohol Syndrome

Another lawsuit focusing on duty-to-warn centers on fetal alcohol syndrome, or drinking during pregnancy, which can lead to birth defects. The first of several such cases goes to trial next April in federal court in Seattle.

The suit, filed by Barry M. Epstein of Newark, N.J.'s Sills Cummis Zucker-Radin Tischman Epstein & Gross, claims "Jim Beam" knew of the dangers of drinking during pregnancy. The suit adds that the company, prior to 1984, did not have a warning on its product concerning birth defects.

Jim Beam, through its attorney, New York's Chadbourne & Parke, denied the allegations and said although the liquor in question — bourbon — does not carry a warning, neither state nor federal law requires it.

Anheuser-Busch is also a defendant in one of the upcoming fetal alcohol syndrome suits, and Ms. Birnbaum

She noted that certain state and municipal laws require establishments serving liquor to place signs warning of the dangers of drinking during pregnancy. For example, the city of Seattle has mounted a public education campaign about the issue.

Another suit involving Anheuser-Busch focuses on the marketing of alcoholic beverages. The suit, in Kentucky, grew out of a serious automobile accident involving an intoxicated driver under the legal drinking age. *Smotherman v. Anheuser-Busch Inc.*, 85-CI-151 (Cir. Ct., Logan Cty.).

David A. Lanphear of Bowling Green, Ky.'s Safford, Satterfield & Lanphear said the case, currently on appeal to the Kentucky Court of Appeals, centers on alleged targeting of the product to underage drinkers.

"They are luring an illegal market to acquire and consume this product," said Mr. Lanphear, claiming that the brewery aims its advertising at 18 to 24 year olds. In Kentucky, the legal drinking age is 21.

Ms. Birnbaum said Anheuser-Busch's argument in that case mirrors that in the others: "It's common knowl-

IN THE
Supreme Court of the United States
OCTOBER TERM, 1988

No. 88-556

BROWNING-FERRIS INDUSTRIES OF VERMONT, INC., and
BROWNING-FERRIS INDUSTRIES, INC.,
v. *Petitioners,*

KELCO DISPOSAL, INC., and JOSEPH KELLEY,
Respondents.

On Writ of Certiorari to the United States
Court of Appeals for the Second Circuit

AMICUS CURIAE BRIEF OF THE UNITED STATES
CHAMBER OF COMMERCE, NATIONAL ASSOCIATION
OF MANUFACTURERS, THE MOTOR VEHICLE
MANUFACTURERS ASSOCIATION OF THE
UNITED STATES, INC., THE BUSINESS ROUNDTABLE,
AMERICAN CORPORATE COUNSEL ASSOCIATION,
RISK AND INSURANCE MANAGEMENT SOCIETY, INC.,
PRODUCT LIABILITY ADVISORY COUNCIL, INC.,
AND THE PRODUCT LIABILITY ALLIANCE
IN SUPPORT OF THE PETITIONERS

STATEMENT OF INTEREST

The United States Chamber of Commerce, National Association of Manufacturers, Motor Vehicle Manufacturers Association of the United States, Inc., the Business Roundtable, American Corporate Counsel Association, Risk and Insurance Management Society, Inc., Product Liability Advisory Council, Inc., and the Product Liability Alliance, with the consent of the parties, hereby file this

8145985202

brief as *amici curiae* in support of the Petitioners.¹ The *amici* and their members represent the interests of the nation's business and manufacturing community.

The U.S. Chamber of Commerce is America's largest federation of businesses, representing more than 180,000 companies, several thousand trade and professional associations, and hundreds of state and local Chambers of Commerce. The National Association of Manufacturers is an association of approximately 13,500 companies and subsidiaries that together employ 85% of all manufacturing workers in the United States and produce more than 80% of the nation's manufactured goods. The Motor Vehicle Manufacturers Association is a trade association whose member companies build motor vehicles and manufacture industrial, lawn and agricultural equipment, construction and mining machinery, locomotives, railroad rolling stock, winches and gasoline and diesel engines for various industrial and agricultural uses.

The Business Roundtable is an association of some 200 chief executive officers of companies from a variety of businesses and geographic locations who examine public issues that affect the economy and develop positions which seek to reflect sound economic and social principles.

The American Corporate Counsel Association is a national bar association of approximately 7500 attorneys from the legal staffs of corporations and other business entities in the private sector who are called upon to advise their clients regarding litigation and settlement of claims filed against them. The Risk and Insurance Management Society, Inc., the world's largest association of risk management professionals, consists of approximately 4,200 industrial and service corporations, governmental bodies and nonprofit organizations.

The Product Liability Advisory Council, Inc., is an association of industrial companies that was formed for

¹ Consent letters have been filed with the Clerk.

the principal purpose of submitting *amicus curiae* briefs in appellate cases involving significant issues affecting the law of product liability. The Product Liability Alliance consists of more than 300 manufacturing businesses, wholesaler-distributors and trade associations from a wide range of industries, and was formed in 1981 for the purpose of seeking uniform federal product liability laws.

This case is of interest to the *amici* because their members and clients are the primary victims of a punitive damages system which the legislatures and the trial and appellate courts have failed to exercise their constitutional duties to control. As the principal voice of the business and manufacturing communities, the *amici* are well suited to present to the Court the effects of unrestrained, disproportionate punitive damage awards on commercial enterprises, and the reasons that such awards violate the Excessive Fines Clause of the Eighth Amendment.

STATEMENT OF THE CASE

This case arises out of a civil action brought by respondent Kelco Disposal, Inc. and Joseph Kelley ("Kelco") in the United States District Court in Vermont, alleging that petitioners Browning-Ferris Industries of Vermont, Inc. and Browning-Ferris Industries, Inc. ("Browning-Ferris") attempted to monopolize the waste-disposal industry in Burlington, Vermont. A jury returned a verdict for Kelco of \$51,146 in compensatory damages on a federal antitrust count, and \$51,146 in compensatory damages and \$6 million in punitive damages on a state law count of tortious interference with contractual relations. Petitioners attacked the \$6 million punitive damages award as a violation of the Excessive Fines Clause of the Eighth Amendment. The Court granted *certiorari* on December 5, 1988. *Browning-Ferris Industries, Inc. v. Kelco Disposal, Inc.*, 109 S. Ct. 527 (1988).

SUMMARY OF ARGUMENT

The Excessive Fines Clause of the Eighth Amendment requires proportionality between the gravity of wrongdoing and the fines that are imposed to punish and deter such wrongdoing, regardless of whether the fines are denominated criminal fines, civil fines, punitive damages awards fixed in amount by statute, or punitive damages awards imposed by juries exercising discretion. The required proportionality cannot systematically obtain, however, if the fines are imposed as punitive damages under laws that (1) only loosely define the conduct and culpability that must be proven before punishment can be imposed, (2) give juries unbridled discretion to choose whether or not to impose punishment once the requisite culpability has been established, (3) provide neither fixed limits nor cognizable standards to guide juries in deciding what amount of punishment to inflict, and (4) provide reviewing courts with no objective standard against which to determine the propriety of punitive damages awards. Because it would be purely fortuitous for punitive damages awarded under such a standardless system to promote proportionality or any other legitimate penal purpose, such awards presumptively violate the Excessive Fines Clause. At a bare minimum, such awards should be subject to heightened scrutiny.

In addition, even if punitive damages are imposed pursuant to guidelines that pass constitutional muster, the proportionality, and therefore the constitutionality, of any particular punishment must be determined by reference to objective standards. At a bare minimum, when a state establishes no standards for determining punitive damages awards, an award violates the Excessive Fines Clause if it exceeds (1) the maximum legislatively established criminal fines for conduct of the same or similar gravity, (2) the maximum legislatively established civil fines for conduct of the same or similar gravity, (3) the maximum legislatively fixed punitive damages awards for misconduct of the same or similar gravity,

and (4) the maximum discretionary punitive damages award judicially approved for conduct of the same or similar gravity in the same state.

STATEMENT

Punitive damages are penal in nature. Punitive damages are intended not to compensate plaintiffs, but to punish defendants, and to deter persons similarly situated from acting improperly in the future.² Because of the characteristics described below, the punitive damages systems in most states fail to further their legitimate purposes.

A. Primary Characteristics of the Prevailing Punitive Damages System

The punitive damages system that exists in the United States today is characterized by: (1) an absence of clear standards for defining the conduct and culpability on which punitive damages may be based; (2) an absence of any standard to determine whether punitive damages should be awarded, once the requisite culpability has been found; (3) an absence of standards for determining the appropriate amount of punitive damages; (4) an absence of objective standards for judicial review; (5) an inappropriate burden of proof; (6) the admissibility of prejudicial evidence of the defendant's wealth even during the trial of liability and compensatory damages issues; and (7) in mass product liability and tort cases, the imposition of multiple punishments for a single act.³

² See W. Prosser & W.P. Keeton, *The Law of Torts* § 2, at 9 (5th ed. 1984); C. McCormick, *Handbook on the Law of Damages* § 77, at 275 (1935); D. Dobbs, *Handbook on the Law of Remedies* § 3.9, at 204 (1973); W. Prosser, J. Wade & V. Schwartz, *Torts: Cases and Materials* 528-29 (8th ed. 1988); M. Franklin & R. Rabin, *Tort Law and Alternatives: Cases and Materials* 622 (4th ed. 1987). See also *International Brotherhood of Electrical Workers v. Foust*, 442 U.S. 42, 48 (1979) (quoting *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 350 (1974)).

³ The first four of these characteristics were present in this case; the last three are additional problems that elsewhere contribute to excessive punitive damages awards.

0245985202

1. *The Absence of Clear Standards for Defining Conduct and Culpability on Which Punitive Damages May Be Based*

The terms used by state courts to describe the conduct or culpability that must serve as the basis for an award of punitive damages are diverse, contradictory and, in most cases, hopelessly vague.⁴ In this case, for example, the district court instructed the jury that punitive damages could be based on "extraordinary misconduct," "outrageous conduct," or "a willful and wanton or reckless disregard of the plaintiff's rights." C.A. 1180. Juries in other states are told to impose damages if they find that the defendant acted with "wanton or reckless disregard for the rights of others." See, e.g., *American Laundry Machinery Industries v. Horan*, 412 A.2d 407, 419 (Md. Ct. Spec. App. 1980). Other states say that "gross negligence" is enough. See Tex. Civ. Prac. & Rem. Code Ann. § 41.003 (Vernon 1987). Some speak of "rudeness" or mere "caprice." See *Newton v. Standard Fire Insurance Co.*, 291 N.C. 105, 112, 229 S.E.2d 297, 301 (1976). None of those terms is defined or circumscribed by objective guidelines.

2. *The Absence of Standards for Determining Whether Punitive Damages Should Be Awarded, Once the Requisite Culpability Has Been Found*

Once it determines that a defendant's misconduct meets the threshold of culpability, the jury has unbridled discretion to award or withhold punitive damages. See W. Prosser & W.P. Keeton, *The Law of Torts*, supra n.2, § 3, at 14. The jury is given no standard or guideline describing how to exercise that discretion. The jury simply is instructed that it may award punitive dam-

⁴ For a comprehensive survey of state laws concerning punitive damages, see R. Schloerb, R. Blatt, R. Hammesfahr & L. Nugent, *Punitive Damages: A Guide to the Insurability of Punitive Damages in the United States and Its Territories* (1988).

ages to the plaintiff if it finds the defendant acted with the requisite culpability. See, e.g., C.A. 1180.

3. *The Absence of Standards for Determining the Appropriate Amount of Punitive Damages*

The great majority of states, including Vermont, establish no standards or guidelines that juries or courts must use to determine the maximum permissible award in a case. No relationship is established between the harm caused and the size of the punitive award, or between compensatory damages and punitive damages. Nor is any relationship established to parallel criminal fines, civil fines, or prior punitive damages awards in the same jurisdiction. Unlike criminal fines and civil fines denominated as such, no standard is established to ensure that punishments in cases involving the same misconduct are approximately the same. Nor is there any amount of punitive damages that a jury may award under the general punitive damages laws.⁵

Generally, as in this case, no instruction is given as to what must be considered or what must not be considered by the jury in determining the amount of punishment. No instruction regarding the deterrent and retributive functions of compensatory damages and defense costs is given.

The clearest point in most instructions is an invitation to consider the defendant's wealth. See, e.g., *Wangen v. Ford Motor Co.*, 97 Wis. 2d 260, 294 N.W.2d 437, 459-60 (1980); *Sturm, Ruger & Co. v. Day*, 594 P.2d

⁵ A few states have enacted specific limitations on general punitive damages awards. See, e.g., Conn. Gen. Stat. Ann. § 52-240b (West 1988) (punitive damages limited to two times compensatory damages); Colo. Rev. Stat. § 13-21-102 (Supp. 1986) (punitive damages limited to amount of actual damages; Fla. Stat. Ann. § 768.73 (West Supp. 1988) (punitive damages limited to three times compensatory damages).

38, 47-48 (Alaska 1979). As a result, the jury's only meaningful guideline for determining the amount of a punitive award is often the size of the defendant's purse. See D. Hensler, M. Vaiana, J. Kakalik & M. Peterson, *Trends in Tort Litigation, The Story Behind the Statistics* 21 (1987).

4. The Absence of Objective Standards for Judicial Review

The absence of standards to support either an award of punitive damages or calculation of the amount undermines the effectiveness of the trial courts' power to invoke remittitur, and the appellate courts' power to reverse. Most appellate courts reduce punitive damages awards only if they somehow intuit them to be infected by "passion or prejudice." Others, such as courts in Vermont, will take action only if they somehow conclude that the award is "manifestly and grossly excessive." *Pezzano v. Bonneau*, 133 Vt. 88, 91, 329 A.2d 659, 661 (1974).

In making these determinations, the courts themselves do not apply objective standards. Instead they substitute their own subjective notions for those of the juries. As one court candidly conceded, "Our reaction is admittedly visceral." *Rosenbloom v. Metromedia, Inc.*, 289 F. Supp. 737, 749 (E.D. Pa. 1968), *rev'd on other grounds*, 415 F.2d 892 (3d Cir. 1969), *aff'd*, 403 U.S. 29 (1971).

5. Inappropriate Burdens of Proof

The Constitution requires that criminal cases be proved "beyond a reasonable doubt" and that certain civil cases be proved by "clear and convincing evidence." *In re Winship*, 397 U.S. 358, 364, 368 (1970) (criminal proceedings); *Santosky v. Kramer*, 455 U.S. 745, 762 (1982) (civil custody proceedings). Nevertheless, for punitive damages, most courts have held that proof by a mere "preponderance of the evidence" standard is

enough. See J. Ghiardi & J. Kircher, *Punitive Damages: Law and Practice* § 9:12 (1985).⁶

6. Admissibility of Prejudicial Evidence

Only five states require bifurcated proceedings separating the trial of punitive damages from other issues.⁷ Thus, most plaintiffs who seek punitive damages may introduce evidence of the defendant's wealth during their case in chief. Although such evidence is admissible only for the narrow purpose of determining the amount of punishment, the jury cannot effectively exclude it in determining whether the defendant is liable, the amount of compensatory damages to award, and whether the culpability required for punitive damages has been established.

7. Multiple Punitive Damage Awards for a Single Act

Manufacturers of products found by juries to be defective can be exposed repeatedly to punitive damage assessments.⁸ The current punitive damages system has

⁶ Several states recently have recognized the penal nature of punitive damages and have imposed a higher burden of proof. At least nineteen states now require proof by "clear and convincing evidence" for punitive damages. See, e.g., Ala. Code § 6-11-20 (Supp. 1987); Alaska Stat. § 09.17.020 (1986); *Linthicum v. Nationwide Life Insurance Co.*, 150 Ariz. 326, 723 P.2d 675 (1986); Cal. Civ. Code § 3294(a) (West 1989). One state, Colorado, uses proof "beyond a reasonable doubt," the level of proof used in criminal cases. See Colo. Rev. Stat. § 13-25-127(2) (Supp. 1986).

⁷ See Conn. Gen. Stat. § 52-240b (Supp. 1987); Ga. Code Ann. § 51-12-5.1(d)(2) (Supp. 1988); Kan. Stat. Ann. § 60-3701 (Supp. 1987); Mo. Ann. Stat. § 510.263 (Supp. 1989) (bifurcation if requested by any party; Mont. Code Ann. § 27-1-221(7)(a) (1987). One state, New Jersey, has a trifurcated procedure. See N.J. Rev. Stat. § 2A:58C-5(e) (1987) (first proceeding on compensatory damages; second proceeding on punitive damages liability; third proceeding on the amount of punitive damages). Colorado does not allow evidence of the defendant's income or net worth to be considered at all. See Colo. Rev. Stat. § 13-21-102(6) (Supp. 1986).

⁸ Serial trials frequently result in disparate punitive damage awards in different cases arising from exactly the same facts. For example, numerous product liability cases were filed against the

ZZH598520Z

developed no effective way to account for this phenomenon—each jury visits the question as if it were the only one looking at punitive damages.

B. Effects of the Current Punitive Damages System

A comprehensive analysis of jury verdicts in the United States prepared by the RAND Institute for Civil Justice shows that the growth in the average award in product liability suits "has been truly explosive, reflecting increases ranging from 200 to more than 1000 percent" from the period 1960-1964 to 1980-1984. D. Hensler, M. Vaiana, J. Kakalik & M. Peterson, *Trends In Tort Litigation: The Story Behind The Statistics*, *supra*, p. 8, at 18. That explosion has been paralleled by a dramatic increase in both the frequency and the size of punitive damages awards against manufacturers.

Before 1970, for example, there was only one reported appellate court decision upholding an award of punitive damages in a product liability case, an award of \$250,000. *See Toole v. Richardson-Merrell, Inc.*, 251 Cal. App. 2d 689, 60 Cal. Rptr. 398 (1967). Today, hardly a month goes by without a multi-million-dollar punitive damages verdict against a manufacturer.⁹

manufacturer of the drug Bendectin. These claims have resulted in jury verdicts in favor of the defendant (*see, e.g., Will v. Richardson-Merrell, Inc.*, 647 F. Supp. 544 (S.D. Ga. 1986)); summary judgment for the defendant on the issue of liability for compensatory damages (*see, e.g., Lynch v. Merrell-National Laboratories, Div. of Richardson-Merrell, Inc.*, 830 F.2d 1190 (1st Cir. 1987) (affirming district court's grant of summary judgment for defendant because plaintiffs failed to show Bendectin caused birth defects)); summary judgment for the defendant on the issue of punitive damages (*see, e.g., Hagen v. Richardson-Merrell, Inc.*, 697 F. Supp. 334 (N.D. Ill. 1988)); and a jury verdict of a punitive damages award for \$75 million (*see Ealy v. Richardson-Merrell, Inc.*, 15 Prod. Safety & Liab. Rep. (BNA) 740 (D.D.C. Oct. 1, 1987) (punitive damages remitted to zero)).

⁹ *See, e.g., Stambaugh v. International Harvester Co.*, 102 Ill. 2d 250, 464 N.E.2d 1011 (1984) (\$15 million punitive damages verdict,

The empirical data show that the standardless punitive damages systems described above, selectively aimed at corporations and other "deep pockets,"¹⁰ have had drastically deleterious effects on the range of products made available to further the health, comfort, and productivity of the American public, and on the ability of manufacturers equitably to settle other claims. Some of these effects are discussed below.

1. Withdrawal of Products From the Marketplace

The general aviation industry produced 18,000 aircraft per year in 1978 and 1979, but fewer than 1,000 in 1988. *See* H.R. Rep. No. 748, 100th Cong., 2d Sess.

remitted to \$650,000); *Cessna Aircraft Co. v. Fidelity & Casualty Co.*, 616 F. Supp. 671, 673 (D.N.J. 1985) (\$25 million punitive damages verdict); *Ford Motor Co. v. Durrill*, 714 S.W.2d 329 (Tex. Ct. App. 1986) (\$100 million punitive damages verdict, remitted to \$10 million); *Tetuan v. A.H. Robins Co.*, 241 Kan. 441, 738 P.2d 1210 (1987) (\$7.5 million punitive damages verdict); *Ealy v. Richardson-Merrell, Inc.*, 15 Prod. Safety & Liab. Rep. (BNA) 740 (D.D.C. Oct. 1, 1987) (\$75 million punitive damages verdict, remitted to zero); *Kemner v. Monsanto Co.*, 15 Prod. Safety & Liab. Rep. (BNA) 884 (Ill. Cir. Ct. Oct. 22, 1987) (\$16.25 million punitive damages verdict); *George v. Raymark Industries, Inc.*, 15 Prod. Safety & Liab. Rep. (BNA) 865 (Del. Super. Ct. Nov. 9, 1987) (\$75 million punitive damages verdict); *O'Gilvie v. International Playtex, Inc.*, 821 F.2d 1438 (10th Cir. 1987), *cert. denied*, 108 S. Ct. 2014 (1988) (\$10 million punitive damages verdict); *Rajala v. Allied Corp.*, No. 82-2282K (D. Kan. Apr. 25, 1988), *appeal docketed*, (10th Cir. May 9, 1988) (\$60 million punitive damages verdict); *Masaki v. General Motors Corp.*, 16 Prod. Safety & Liab. Rep. (BNA) 225 (Haw. Ct. App. Feb. 29, 1988) (\$11.25 million punitive damages verdict), *petition for cert. filed*, 57 U.S.L.W. 3296 (U.S. Oct. 14, 1988); *Batteast v. Wyeth Laboratories, Inc.*, 172 Ill. App. 3d 114, 526 N.E.2d 428 (1988) (\$13 million punitive damages verdict); *FDIC v. W.R. Grace Co.*, 691 F. Supp. 87 (N.D. Ill. 1988) (\$75 million punitive damages verdict).

¹⁰ *See* M. Peterson, S. Sarma & M. Stanley, *Punitive Damages: Empirical Findings* 50 (1987); D. Hensler, M. Vaiana, J. Kakalik & M. Peterson, *Trends in Tort Litigation: The Story Behind The Statistics*, *supra* p. 8.

2025985272

24 (pt. 1) (1987) (statement of Edward W. Stimpson, President, General Aviation Manufacturers Assoc., Before the House Subcomm. on Commerce, Consumer Protection and Competitiveness). The decreased production was heavily influenced by punitive damages awards in cases such as *Cannuli v. Cessna Aircraft Co.*, Nos. 80-3285, 81-2209, 82-1052 (D.N.J. 1984) (\$25 million).

United States manufacturers of medical equipment similarly have abandoned certain markets. For example, Puritan-Bennett, a major domestic manufacturer of hospital equipment, stopped making anesthesia gas machines in 1984 because of rising liability costs, leaving two foreign manufacturers to dominate a market once filled by a half-dozen competitors. See Brody, *When Products Turn into Liabilities*, *Fortune*, Mar. 3, 1986, at 22.¹¹

This phenomenon affects even the so-called "leisure" industries. For example, in 1976 there were eighteen manufacturers of football helmets. Now there are two. See Brown, *Insurance Costs, Lawsuits Injure U.S. Sports*, *J. Com.*, July 13, 1988, at A1, col. 2, A14, col. 5.

2. Reduced Development of New and Useful Products

A 1988 Conference Board survey of 4,000 companies in the United States reported: "About a third of all the firms surveyed—and nearly half of those reporting major impacts—have decided against introducing new products because of liability fears." See E.P. McGuire, *The Impact of Product Liability*, vii (1988). Several specific examples of this phenomenon have been reported:

¹¹ An \$8 million punitive damages award against the sole manufacturer of the polio vaccine on the theory that it had produced the wrong type of vaccine (the Sabin rather than the Salk vaccine) "almost jeopardized the viability of the entire polio vaccination program." Fortunately, the decision was reversed by a four-to-three vote of the Kansas Supreme Court in *Johnson v. American Cyanamid Co.*, 239 Kan. 279, 718 P.2d 1318 (1986). R. Willard & R. Willmore, *An Update on the Liability Crisis: Tort Policy Working Group* 51 (1987).

- The President of Unison Industries, Inc., explained that his firm is *withholding an advanced electronic ignition system for light aircraft from the market* because of the liability risk that might result from its release and use. *Id.*
- The Chairman of the Board of Union Carbide Corporation reported that his company decided to *forgo development of a suitcase sized kidney dialysis unit* because "we believed [the] size of any damage claims and the probable cost of defending ourselves, made the whole thing uneconomic." Remarks of W. Anderson at the Annual Meeting of National Association of Casualty and Surety Executives (Oct. 7, 1986). He further reported that "it was the same reason we decided to *forgo offering IV equipment and the food packages for intravenous feeding* to our medical oxygen customers. It would have been a good service and a good business, but the costs of defending ourselves against the inevitable lawsuits caused us to drop it." *Id.* at 3 (emphasis added).

Similarly, the Chairman and Chief Executive Officer of Monsanto Company reported that, because of the uncertain punitive damages system, Monsanto

abandoned a possible substitute product for asbestos just before commercialization, not because it was unsafe or ineffective, but because a whole generation of lawyers had been schooled in asbestos liability theories that could possibly be turned against the substitute.

See Mahoney, *Punitive Damages: The Courts are Curb-ing Creativity*, *N.Y. Times*, Dec. 11, 1988, § 3, at 3, col. 1.

The project director for the National Academy of Sciences report, *Confronting AIDS—Directions for Public Health, Health Care, and Research*, stated, "[T]his general climate of uncertainty is something that deters many pharmaceutical companies from being involved in

AIDS vaccine research." See *Insurance Costs Deter AIDS Vaccine*, 1 Liab. & Ins. Bull. (BNA), at 5 (Nov. 3, 1986).

3. Effects on Settlements

A study conducted by the United States Department of Justice on the liability crisis indicated that uncertainties in the punitive damages system "serve as a significant obstacle to the settlement process by giving the plaintiff unrealistic expectations of the value of his case even where the defendant has made a generous settlement offer." See R. Willard & R. Willmore, *An Update on the Liability Crisis: Tort Policy Working Group*, *supra* n.11. "It is close to impossible to negotiate sensibly with a plaintiff who believes that he can shoot for the moon." *Id.* (quoting Twerski, *A Moderate and Restrained Federal Product Liability Bill: Targeting the Crisis Areas for Resolution*, 18 U. Mich. J.L. Ref. 575, 612 (1985)). Empirical data indicate that, in those claims in which claimants sought punitive damages, claim settlements rose an average of about ten percent. See ISO DATA, Inc., *Claim File Data Analysis: Technical Analysis of Study Results* 86-87 (Dec. 1988).

In sum, the lack of standards and arbitrariness of the punitive damages system has had a substantial and adverse impact on productivity in the United States.

ARGUMENT

I. PUNITIVE DAMAGES JUDGMENTS BASED ON UNCHANNELED JURY DISCRETION PRESUMPTIVELY VIOLATE THE EXCESSIVE FINES CLAUSE OF THE EIGHTH AMENDMENT

The general punitive damages laws of Vermont and many other states give juries license to inflict such punishments arbitrarily and on the basis of prejudice. They permit juries to set the amount of punishment without reference to any cognizable standard. And they provide no objective standard for judicial review.

Under such systems, any relationship between the punishments imposed and the legitimate purposes of punishment is purely fortuitous. When a state chooses to employ a system that does little or nothing to ensure that punitive awards are even minimally channeled to promote their avowed legitimate purposes, punishments imposed under that system presumptively violate the Excessive Fines Clause of the Eighth Amendment.

A. The Excessive Fines Clause Requires Proportionality

In *Solem v. Helm*, 463 U.S. 277, 290 (1983), the Court held that the Eighth Amendment requires "that a criminal sentence must be proportionate to the crime for which the defendant has been convicted." Although the Court was there applying the Cruel and Unusual Punishment Clause to an excessive prison sentence, the Court observed that the amendment "imposes 'parallel limitations' on bail, fines, and other punishments." 463 U.S. at 289 (quoting *Ingraham v. Wright*, 430 U.S. 651, 664 (1977)). Also, in explaining why the Cruel and Unusual Punishment Clause requires proportionality for prison sentences, the Court took as beyond dispute that the Excessive Fines Clause requires proportionality for fines. See 463 U.S. at 288-90. Finally, in describing the proportionality requirement's roots in Magna Carta, the Court observed that the requirement derived from Magna Carta's prohibition against disproportionate amercements, which were "similar to a modern-day fine." 463 U.S. at 283 n.8 and accompanying text. Accordingly, *Solem* teaches that proportionality between the wrongs inflicted and the fines imposed is the bedrock requirement of the Excessive Fines Clause.¹²

¹² As shown at length by the brief *amicus curiae* submitted by *Golden Rule Insurance Co., et al.*, the history of the Excessive Fines Clause leaves no doubt that the clause was intended to apply to civil as well as criminal fines. See generally Jeffries, *A Comment on the Constitutionality of Punitive Damages*, 72 Va. L. Rev. 139 (1986);

52h5985202

B. Punitive Damages Awards Based on Unchanneled Jury Discretion Fail to Provide Proportionality or to Promote Any Other Legitimate Penal Purpose

The very essence of the proportionality requirement is consistency in the relationship between punishment and wrongdoing from case to case: the punishment imposed in one case for a particular misdeed must be similar in severity to punishments imposed in other cases for misdeeds of similar gravity, greater than punishments imposed in other cases for misdeeds of lesser gravity, and less than punishments imposed in other cases for misdeeds of greater gravity. Magna Carta indicated as much:

A freeman shall not be amerced for a slight offence, except in accordance with the degree of the offence; and for a grave offence he shall be amerced in accordance with the gravity of the offence

Magna Carta, ch. 20, quoted in W. McKechnie, *Magna Carta* 284 (2d ed. 1958). So has the Court. See *Solem*, 463 U.S. at 284-85. So, too, have moral philosophers of virtually every persuasion. See generally Wheeler, *Toward a Theory of Limited Punishment: An Examination of the Eighth Amendment*, 24 Stan. L. Rev. 838, 845-57 (1972), (discussing I. Kant, *The Philosophy of Law* 194-98 (W. Hastie transl. 1887); J. Bentham, *An Intro-*

Note, Punitive Damages and the Eighth Amendment: An Analytical Framework for Determining Excessiveness, 75 Cal. L. Rev. 1433, 1441-47 (1987); *Note, The Constitutionality of Punitive Damages Under the Excessive Fines Clause of the Eighth Amendment*, 85 Mich. L. Rev. 1699 (1987). This Court has recognized punitive damages as a form of civil fine. See *International Brotherhood of Electrical Workers v. Foust*, 442 U.S. 42, 48 (1979); *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 350 (1974); *Smith v. Wade*, 461 U.S. 30, 59 (1983) (Rehnquist & Powell, JJ., & Burger, C.J., dissenting); *Rosenbloom v. Metromedia, Inc.*, 403 U.S. 29, 82 (1971) (Marshall, J., dissenting). This brief therefore does not further address the question of the Excessive Fines Clause's applicability to punitive damages judgments.

duction to the Principles of Morals and Legislation 178-91 (1789)).

The proportionality requirement is a vital corollary of the broader constitutional prohibition "against arbitrary and discriminatory punishment." *Giaccio v. Pennsylvania*, 382 U.S. 399, 402 (1966) (applying Due Process Clause). See *Yick Wo v. Hopkins*, 118 U.S. 356, 370 (1886). As the Court has recognized in a variety of contexts, the required consistency and prevention of arbitrariness and unjust discrimination cannot be achieved unless punishments are imposed pursuant to cognizable, objective standards. See *Gregg v. Georgia*, 428 U.S. 153, 189 (1976) (plurality opinion) ("It is certainly not a novel proposition that discretion in the area of sentencing be exercised in an informed manner. . . . Otherwise, 'the system cannot function in a consistent and rational manner.'"); cf. *Giaccio*, 382 U.S. at 402 (Due Process Clause violated by "vagueness and the absence of any standards sufficient to enable defendants to protect themselves against arbitrary and discriminatory imposition of costs"). In the absence of such standards, juries can silently base their decisions to punish, and the severity of their punishments, upon invidious discrimination, prejudice, and even whim. Every punishment so motivated, no matter how small, would be excessive. See *Robinson v. California*, 370 U.S. 660, 667 (1962) ("Even one day in prison would be a cruel and unusual punishment for the 'crime' of having a common cold.").

Punishments therefore must be constrained by cognizable limits and guidelines fixed before the defendant has acted. See *United States v. Batchelder*, 442 U.S. 114, 123 (1979) ("vague sentencing provisions may pose constitutional questions if they do not state with sufficient clarity the consequences of violating a given criminal statute"); *Giaccio*, 382 U.S. at 405 n.8 (referring to constitutionality of allowing juries "to fix punishment within legally prescribed limits") (emphasis added).

92h5985202

A related constitutional infirmity in a system that allows the imposition of fines not limited by predetermined standards is this: such a system violates the principle of fundamental fairness reflected in the Constitution's proscription of *ex post facto* laws, a proscription that invalidates "[e]very law that changes the punishment, and inflicts a greater punishment, than the law annexed to the crime, when committed." *Calder v. Bull*, 3 U.S. (1 Dall.) 386, 390 (1798) (Chase, J., separate opinion).¹⁸

Without predetermined standards for punishments, the *ex post facto* principle would be eviscerated. When a state's legislature and courts leave the size of fines to juries' unchanneled discretion, no fine of any magnitude can ever be said to have changed the punishment or to have inflicted a punishment greater than that allowed when the wrongdoing was committed.

The general punitive damages laws of Vermont and most other states violate these excessiveness principles. Because the jury's decision whether to award punitive damages, once the requisite culpability has been established, is unreviewable and may be based upon anything at all, it would be pure happenstance if any particular punitive award were to be proportionate to the wrongdoing committed or serve any other legitimate purpose. In other instances of the same (or more culpable) conduct by other defendants, juries may have awarded only compensatory damages and refrained, on the basis of bias, caprice, or sympathy, from awarding punitive damages. *Cf. Furman v. Georgia*, 408 U.S. 238, 309-10 (1972) (Stewart,

¹⁸ Accord *Lindsey v. Washington*, 301 U.S. 397, 401 (1937) ("The Constitution forbids the application of any new punitive measure to a crime already consummated, to the detriment or material disadvantage of the wrongdoer."); *In re Medley*, 134 U.S. 160, 171 (1890) ("no one can be criminally punished in this country except according to a law prescribed . . . before the imputed offense was committed, or by some law passed afterwards, by which the punishment is not increased").

J., concurring) (Capital punishment imposed under the challenged statute was "cruel and unusual in the same way that being struck by lightning is cruel and unusual. For, of all the people convicted of [capital crimes], many just as reprehensible as these, the petitioners [were] among a capriciously selected random handful upon whom the sentence of death has in fact been imposed.")¹⁴

It is no answer for Vermont and others to assert that this is merely an exercise of jury discretion. *See, e.g., Pezzano v. Bonneau*, 133 Vt. 88, 90, 329 A.2d 659, 660. The authority that juries are exercising is not "discretion in the legal sense of that term, but . . . mere will. It is purely arbitrary and acknowledges neither guidance nor restraint." *Yick Wo v. Hopkins*, 118 U.S. at 366-67 (reviewing exercise of discretion in Fifth Amendment context).

[D]iscretion, to be worthy of the name, is not unchanneled judgment; it is judgment guided by reason and kept within bounds. Otherwise, . . . "[i]t is always unknown: It is different in different men: . . . In the best it is oftentimes caprice: In the worst it is every vice, folly, and passion, to which human nature is liable."

McGautha v. California, 402 U.S. 183, 285 (1971) (Brennan, Douglas & Marshall, JJ., dissenting).

¹⁴ Problems with the standardless nature of punitive damages laws arise even in determinations of whether the requisite culpability has been established. Here, for example, the jury was told that punitive damages could be based on "extraordinary misconduct," "outrageous conduct," or "a willful and wanton or reckless disregard of the plaintiff's rights." C.A. 1180. None of those terms was defined. In *Giaccio*, the Court held "reprehensible," "improper," "outrageous to morality and justice," and "misconduct" impermissibly vague as tests for juries to employ in deciding whether to require an acquitted defendant to pay \$230.95 in court costs. 382 U.S. at 403. *See also Smith v. Wade*, 461 U.S. 30, 88 (1983) (Rehnquist & Powell, JJ., & Burger, C.J., dissenting) ("a vaguely defined, elastic standard like 'reckless indifference' gives free reign to the biases and prejudice of juries").

Nor is it prohibitively difficult for legislatures or courts to establish limits on, or objective standards for, punitive damages awards in order to ensure at least rough proportionality. Vermont, for example, has fixed maximum criminal fines for the entire panoply of criminal acts (*see, e.g.*, Appendix "C"); maximum civil penalties for a wide variety of civil misconduct (*see, e.g.*, Appendix "B"); and maximum punitive damages for still other civil misconduct (*see, e.g.*, Appendix "A"). Some of these fixed civil fines and punitive awards are for conduct that is similar in effect and culpability to antitrust conduct. *See, e.g.*, Vt. Stat. Ann. tit. 9, § 2461 (1984 & Supp. 1986) (treble damages for consumer fraud); Vt. Stat. Ann. tit. 5, § 1819 (1972 & Supp. 1986) (civil fines of specified sums for granting or consenting to special rebates). And, of course, Congress and dozens of state legislatures have established treble damages as the appropriate punitive damages for antitrust conduct such as the predatory pricing at issue in this case.

Nor has the application of these standardless laws, accompanied by an instruction that punitive damages are to punish and deter, generated a body of discernible, consistently applied common law guidelines. As the Court stated in another context:

All of the so-called court-created conditions and standards still leave to the jury such broad and unlimited power . . . that the jurors must make determinations of the crucial issue upon their own notions of what the law should be instead of what it is.

Giaccio, 382 U.S. at 403.

Predictably, this system has resulted not in consistent application of sound principles, but in identifiable discrimination against at least one group: corporate defendants. Researchers for the RAND Institute of Civil Justice concluded that "[c]orporate defendants are in fact more likely than individuals or public agents to be

the target of [punitive damages] awards" and that "[p]unitive awards against businesses were far larger than those against individuals in both personal injury and business/contract cases." M. Peterson, S. Sarma & M. Stanley, *Punitive Damages: Empirical Findings*, *supra* n. 10.

The excessiveness of punitive damages also results from unchanneled discretion exercised by juries in fixing the *amount* of the awards after the decision to impose punishment has been made. In various opinions in the last two decades, the Court has explicitly stated as much.¹⁵

Once again, neither proportionality nor any other cognizable standard is likely to be satisfied under these con-

¹⁵ *See Gertz*, 418 U.S. at 350 (punitive damages laws leave juries "free to use their discretion selectively to punish expressions of unpopular views") (Powell, Marshall, Blackmun & Rehnquist, JJ.); *Foust*, 442 U.S. at 50 n.14 ("punitive damages may be employed to punish unpopular defendants") (Marshall, J., joined by Brennan, Stewart, White & Powell, JJ.); *Smith v. Wade*, 461 U.S. at 59 ("punitive damages are frequently based upon the caprice and prejudice of jurors") (Rehnquist, J., Burger, C.J. & Powell, J., dissenting); *cf. City of Newport v. Fact Concerts, Inc.*, 453 U.S. 247, 270 (1981) ("Because evidence of a tort-feasor's wealth is traditionally admissible as a measure of the amount of punitive damages that should be awarded, the unlimited taxing power of a municipality may have a prejudicial impact on the jury, in effect encouraging it to impose a sizable award.") (Blackmun, J., joined by Burger, C.J., Stewart, White, Powell & Rehnquist, JJ.); *Rosenbloom v. Metromedia, Inc.*, 403 U.S. at 74-75 (when punitive damages "bear no relationship to the actual harm caused, they then serve essentially as spring-boards to jury assessment, without reference to the primary legitimating compensatory function of the system, of an 'infinitely wide range of penalties wholly unpredictable in amount. Further, I find it difficult to fathom why it may be necessary, in order to achieve its justifiable deterrence goals, for the State to permit punitive damages that bear no discernible relationship to the actual harm caused.") (Harlan, J., dissenting); *id.* at 84 ("This discretion allows juries to penalize heavily the unorthodox and the unpopular and exact little from others.") (Marshall, J., dissenting).

ditions. Because juries are not even told that the punishment they inflict should be proportionate to the wrongdoing involved, and because they are not told what punishments have been imposed for similar misconduct in other cases, any case-to-case consistency in the relationship between the severity of punishment and the gravity of wrongdoing must be purely fortuitous. Similarly, because juries are not given any guidance regarding the principles of deterrence or retribution, any relationship between those principles and the juries' awards must be wholly accidental.

Moreover, effective deterrence does not require such untrammelled discretion. Deterrence theory assumes that potential actors will rationally weigh the benefits and costs likely to flow from contemplated wrongful conduct. Rational deterrence obtains, therefore, only if the actors are informed about the magnitude of the costs, including punishments, they are likely to incur if they engage in the proscribed conduct. If laws fail to establish standards for punitive damages awards, actors contemplating wrongful conduct can only guess at the likely consequences of their misdeeds.

Rational deterrence also requires that punishment be imposed in the amount, and only in the amount, necessary to ensure that the actors' expected costs (i.e., actual costs adjusted upward to account for the probability that the conduct will not be detected and successfully prosecuted by injured persons and that punishment will not be imposed), will equal any gain that they would otherwise expect to obtain from the contemplated wrongful conduct. See H. Packer, *The Limits of the Criminal Sanction* 45-48 (1968); Ellis, *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. Cal. L. Rev. 1, 23-24, 43-53 (1982); Note, *Punitive Damages for Libel*, 98 Harv. L. Rev. 847, 849-51 (1985). Punishment in any other amount will either deter desirable activity or fail to deter undesirable activity.

Punitive awards imposed pursuant to standardless jury submissions also fail to serve the state's retributive pur-

poses. The basic test of the propriety of punishment as retribution is that the punishment must be proportionate to the wrongdoing. See Wheeler, *Toward a Theory of Limited Punishment: An Examination of the Eighth Amendment*, 24 Stan. L. Rev. 838, 846 (1972). Punitive damages imposed pursuant to standardless jury submissions violate the proportionality requirement, as already shown above.

The \$6 million punitive award against Browning-Ferris in this case illustrates the vices of the standardless scheme. First, an award of that size was unpredictable. Browning-Ferris could not have known that its pricing activities could result in such an award. The highest reported prior punitive damages award under Vermont law, for any type of conduct of even the most heinous nature, had been only \$300,000, in *Greenmoss Builders, Inc. v. Dunn & Bradstreet, Inc.*, 143 Vt. 66, 461 A.2d 414 (1983), *aff'd*, 472 U.S. 749 (1985). See Appendix "E."

Similarly the \$6 million award was in the nature of an *ex post facto* increase in the punishment for Browning-Ferris' conduct. All prior conduct of the same or greater degree of culpability, or that had caused actual harm equal to or greater than that caused by Browning-Ferris, had resulted in punitive damages in markedly lower amounts, or in no punitive damages at all.

Further, and for the same reason, the \$6 million punitive award cannot be said to be proportionate to the gravity of Browning-Ferris' wrongdoing. It is improbable that, in the 200-year history of Vermont, no more heinous act had ever been committed and presented to a jury by a plaintiff seeking punitive damages. It is even more improbable that, as implied by the twenty-to-one ratio between the \$6 million award and the previous highest award of \$300,000, Browning-Ferris' pricing activities were approximately twenty times more heinous, harmful or difficult to deter than any previous act by any person or entity in Vermont history.

Finally, the \$6 million punitive damages award cannot be said to be justified by the injury inflicted by Browning-Ferris' misconduct, or the wrongful gain that the misconduct might reasonably have been expected to generate. The jury found that the injury was only \$51,146. And the only "gain" derived by Browning-Ferris was its loss of greater and greater amounts of business to Kelco, such that Browning-Ferris ultimately had to leave the market altogether. Even if a substantial adjustment were made to account for the possibility that Browning-Ferris' challenged pricing practices might have proved more successful, the sum required to deter such conduct would not approach \$6 million.

In sum, it is apparent that punitive damages are imposed in Vermont pursuant to laws that specify no limits, no required relationship to culpability, no required relationship to the punishments for other acts of wrongdoing, and no other objective standards for determining when and in what amount they are to be imposed. Punitive awards thus imposed serve no valid state interest.¹⁶ Under these circumstances, the state's legislature, or its courts through common law development, should be required to "replac[e] arbitrary and wanton jury discretion with objective standards to guide, regularize, and make rationally reviewable the process for imposing [punishment]." *Woodson v. North Carolina*, 428 U.S. 280, 303 (1976).¹⁷

¹⁶ As the Court previously has declared, "[s]tates have no substantial interest in securing for plaintiffs gratuitous awards of money damages far in excess of any actual injury." *Gertz v. Robert Welch, Inc.*, 418 U.S. at 349.

¹⁷ See generally *United States v. Evans*, 333 U.S. 483, 486 (1948) ("In our system, so far at least as concerns the federal process, defining crimes and fixing penalties are legislative, not judicial functions."); *United States v. Batchelder*, 442 U.S. at 125-26 (discussing "the Legislature's responsibility to fix criminal penalties"); *Gregg v. Georgia*, 428 U.S. at 174 n.19 (plurality opinion) ("legislative measures adopted by the people's chosen representatives provide one important means of ascertaining contemporary values").

In particular, the state's legislature or courts should be required to establish objective standards to guide and limit juries in determining when, and in what amounts, punitive awards may be imposed. At a bare minimum, if the state's legislature and courts choose to continue to abdicate that responsibility, punitive awards under that state's laws should be subjected to heightened judicial scrutiny under the Eighth Amendment.

II. A PUNITIVE DAMAGES AWARD THAT EXCEEDS EVERY LEGISLATIVELY ESTABLISHED MAXIMUM CRIMINAL FINE AND CIVIL FINE, INCLUDING LEGISLATIVELY ESTABLISHED PUNITIVE DAMAGES, FOR LIKE CONDUCT IN THE SAME AND OTHER STATES VIOLATES THE PROPORTIONALITY REQUIREMENT OF THE EXCESSIVE FINES CLAUSE

Even when a state has specified limits on the punishments permitted for various forms of wrongful conduct and has thereby provided objective guidelines regarding proportionality, a punishment *within* those limits may nevertheless violate the Excessive Fines Clause. *Solem*, 463 U.S. 277. In deciding whether such a violation exists,

a court's proportionality analysis under the Eighth Amendment should be guided by objective criteria, including (i) the gravity of the offense and the harshness of the penalty; (ii) the sentence imposed on other criminals in the same jurisdiction; and (iii) the sentences imposed for commission of the same crime in other jurisdictions.

Solem, 463 U.S. at 292.

Although that holding was articulated in the context of a proportionality analysis of a legislatively fixed maximum prison sentence, the principle that Eighth Amendment proportionality analysis should be guided by objective criteria applies with equal force to other forms of punishment, including civil fines. See *Solem*, 463 U.S. at

289 ("Eighth Amendment imposes 'parallel limitations' on bail, fines, and other punishments" (quoting *Ingraham*, 430 U.S. at 664)). If, as occurred here, the punishment has been imposed under a system with no specified limit or guideline, it can overcome its presumptive excessiveness only if its relationship to the available objective criteria can be demonstrated under a heightened Eighth Amendment scrutiny.¹⁸

The sources of relevant objective criteria are plentiful. To analyze the proportionality of a punitive damages

¹⁸ The court of appeals below did not consider the *Solem* proportionality criteria or any related criteria. Instead, because the punitive award was less than one percent of the defendants' net worth, the court concluded that the award "was not inconsistent with punitive damages levied in other jurisdictions against large corporations" and "was not motivated by prejudice." 845 F.2d at 410.

There is neither a retributive nor deterrent rationale for the court of appeals' approach. If a defendant is to be punished, it should be punished for the gravity of the misdeed (as roughly indicated, for example, by the harm caused or threatened), not for the fact of being large. Especially where the misdeed is a purely economic one, such as pricing activity, the defendant's status has no legitimate retributive role.

Nor is a larger penalty necessary for deterrence. The size of the penalty needed for deterrence is determined by reference to the expected gain from the specific misconduct. Because it is often enough the case that the defendant's expected gain is equal to the plaintiff's expected loss (theft cases being one example), it makes sense to use compensatory damages as a rough measure of expected wrongful gain and, accordingly, as the basis for the appropriate punitive damages awards. But no such theory of deterrence makes the size of the penalty awarded for deterrence turn on the defendant's wealth. To the contrary, in most instances, a penalty that, together with compensatory damages and other costs, is sufficient to make the expected cost exceed the expected gain will deter the undesirable conduct. Cf. *Smith v. Wade*, 461 U.S. at 94 (O'Connor, J., dissenting) ("awards of compensatory damages and attorney's fees already provide significant deterrence"). That will be true regardless of the actor's wealth; General Motors is no more likely than a small, specialty-car manufacturer to engage in misconduct whose expected cost exceeds the expected gain.

award for a particular misdeed, a court can look to (1) the criminal fines imposed in other instances in the same and other jurisdictions; (2) civil fines authorized for similar conduct in the same state and in other states; (3) civil fines in the nature of legislatively fixed punitive damages awards (whether fixed dollar sums, fixed multiples of compensatory damages, or sums fixed in some other manner, such as by reference to reasonable attorney's fees) for similar and dissimilar conduct in the same state and in other states; and (4) punitive damages awards imposed by juries, and upheld by courts applying meaningful standards, for similar and dissimilar conduct in the same state.

To determine whether the \$6 million punitive damages award in this case is excessive under the Eighth Amendment, the Court need not decide whether a punitive damages award that exceeds any one, or even two or three, of these objective standards is excessive. That is because the award in this case exceeds *all* of them. The five charts attached as Appendices "A" through "E" to this brief demonstrate that the punitive damages award of \$6 million greatly exceeds every objective indicium of proportionality provided by the Vermont legislature, by other Vermont juries that have awarded punitive damages, and by every other legislature in the United States (including Congress) that has specified permissible punitive damages or criminal fines for antitrust conduct such as predatory pricing.¹⁹

¹⁹ Appendix "A" shows that the Vermont legislature has specified various forms of limits on punitive damages awards for a wide variety of wrongful conduct. The \$6 million punitive award here is more than 100 times larger than the compensatory damages; yet the largest multiple that the Vermont legislature has specified is a punitive award ten times the sum wrongfully obtained by the defendants, and the largest dollar sum specified is \$10,000.

Similarly, Appendix "B" shows that the Vermont legislature has specified a wide variety of civil fines for a wide variety of wrongful conduct ranging from various fraudulent actions to dan-

1845985202

Thus, to declare the award excessive, the Court need conclude only that, at a bare minimum, when a state establishes no predetermined maximum punitive damages that may be awarded for a particular type of misconduct and allows a jury unguided discretion to award whatever sum they might choose to award, a sum of punitive damages awarded for that misconduct violates the Excessive Fines Clause if it exceeds (1) the maximum legislatively established criminal fine for conduct of the same or similar gravity, (2) the maximum legislatively established civil fine for conduct of the same or similar gravity, (3) the maximum legislatively fixed punitive damages awards for misconduct of the same or similar gravity; and (4) the maximum discretionary punitive damages award in a final judgment for conduct of the same or similar gravity in the same state.

In sum, the punitive damages judgment in this case vastly exceeds every legislatively established penalty,

gerous uses of radioactive material. The punitive award in this case is some 300 times larger than the largest civil fine for which a dollar maximum is specified.

Appendix "C" lists a wide variety of the legislatively established criminal fines in the State of Vermont. The punitive damages award in this case exceeds by millions of dollars, and by a multiple of more than 200, any specified fine for any nonviolent crime in the State of Vermont.

Appendix "D" shows that the punitive damages award in this case also vastly exceeds the legislatively specified maximum punitive damages for predatory pricing activity in every one of the forty-three states that specifies a measure of punitive damages for antitrust conduct. See also 15 U.S.C. § 15 (1982) (specifying treble damages and reasonable attorneys' fees as relief in antitrust actions).

Appendix "E" shows that the judgment also exceeded every reported prior punitive damages award, for every type of conduct, no matter how serious, how violent, or how harmful, in the history of the State of Vermont. See, e.g., *Greenmoss Builders, Inc.*, 143 Vt. 66, 461 A.2d 414 (punitive damages judgment of \$300,000 for libel).

civil or criminal, for any form of nonviolent wrongful conduct in the State of Vermont, and every legislatively established punitive damages award for the identical conduct—predatory pricing—in every state in the nation with a specified punitive damages award for that type of conduct. If the Excessive Fines Clause's prohibition of disproportionate fines is to have any significance, it must require reversal of that judgment.

CONCLUSION

For the foregoing reasons, the judgment of the United States Court of Appeals for the Second Circuit affirming the district court's punitive damages judgment should be reversed.

Respectfully submitted,

VICTOR E. SCHWARTZ
LIBERTY MAHSHIGIAN
CROWELL & MORING
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2505
(202) 624-2500

HERBERT L. FENSTER
STANLEY W. LANDFAIR
MCKENNA, CONNER & CUNEO
1575 Eye Street, N.W.
Washington, D.C. 20005
(202) 789-7500

MALCOLM E. WHEELER
Counsel of Record
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM
Suite 3400
300 South Grand Avenue
Los Angeles, California 90071
(213) 687-5000

Attorneys for the Amici Curiae

2Eh598520Z

The European Economic Community's Council Directive on Product Liability

On June 25, 1985, the Council of the European Economic Community (EEC or Community) issued a Council Directive on the approximation of the laws, regulations and administrative provisions of the member states concerning liability for defective products.¹ The objectives of the Directive are to harmonize the legal environment in the EEC with regard to product liability by abolishing existing differences between the national laws of the member states, thus providing for more competitive equality, and to provide for increased consumer protection against the risks inherent in modern technological production. In order to achieve these aims, the concept of liability without fault was introduced.² Apart from a few statutory exceptions,³ this concept has hitherto been alien to the national laws of the member states.

The concept of non-fault product liability was first adopted by the Commission Recommendation of 1976.⁴ The Commission Recommendation was then submitted to the European Parliament⁵ and the Economic and Social Committee⁶—both organizations suggesting changes—and in 1979 a revised Commission Recommendation was sent to the European Council.

*Deputy Executive Director, German American Chamber of Commerce, Inc.; partner, Dielmann & Schoenberger, Frankfurt.

1. 28 O.J. EUR. COMM. (No. L 210/29) 29 (1985) [hereinafter cited as *Council Directive*].

2. *Id.* at art. II.

3. See *infra* text accompanying notes 10-21.

4. O.J. No. C 241/9, 14 10/1976, p. 9.

5. *Resolution of the European Parliament*, 22 O.J. EUR. COMM. (No. C 127/61), p. 61 (1979).

6. *Opinion of the Economic and Social Committee*, 22 O.J. EUR. COMM. (No. C 114/15) 15 (1979).

for approval.⁷ After controversial discussions and various deadlocks during the following years, it became doubtful whether the European Council would pass the Directive. The present Directive, which constitutes a compromise among the diverging interests of the various member states, was finally adopted during the Italian Presidency.

Notwithstanding its broad scope, the Directive does not create any direct rights of parties injured by defective products, but instead obliges the member states to implement the Directive by adopting laws, regulations and administrative provisions in compliance with the Directive not later than three years from the date of the Directive, i.e., by June 30, 1988. According to art. 189 of the Treaty of Rome establishing the EEC,⁸ a directive is binding upon each member state. Only when a member state fails to adopt implementing legislation within the time period set forth in the directive will the provisions of the directive, to the extent that they are unconditional and sufficiently precise,⁹ be given direct effect.

I. Concept of Non-Fault Liability

In conformity with the Commission Recommendation,¹⁰ art. 1 of the Council Directive provides for strict liability without regard to whether the producer can be charged with negligence.¹¹ The damaged party must demonstrate only that the product was defective and that the defect caused the injury. Apart from some statutory exceptions, this concept is unknown in the member states, where the additional requirement of negligence on the part of the producer is the rule.¹² The producer is negligent when he violates his duty of care with regard to the injured party. While the injured party is generally required to prove in a tort action that the defendant's action caused the damages and that the defendant was at fault, judicial opinions in some member states have shifted the burden of proof on the fault issue to the producer on the basis that the producer is much closer to his production process and that possible defects in the product are within his sphere of risk.¹³

7. *Commission Recommendation*, 22 O.J. EUR. COMM. (No. C 271/3) 3 (1979) [hereinafter cited as *Commission Recommendation*].

8. Treaty Establishing the European Economic Community, done at Rome, March 25, 1957; 298 U.N.T.S. 4. The official English text is found at 2 Common Mkt. Rep. (CCH) ¶ 3815. It is also published in *Treaties Establishing the European Communities* (Office for Official Publications of the European Communities, 1979).

9. Toepke, *E.C. Sets Standards on Product Liability*, EUROPE, NOV. DEC. 1985, p. 20.

10. *Commission Recommendation*, *supra* note 7.

11. *Council Directive*, *supra* note 1, art. 1.

12. See Hollmann, *Die EG-Produkthaftungsrichtlinien*, in 1985 DER BETRIEB 2389 *et seq.* & 2439 *et seq.*

13. See Schwarz, Sabagh, Peltzer & Schuecking, *Produzentenhaftung in den USA und in Deutschland—Product Liability in the USA and in Germany*, 66 (English-German publication, GERMAN-AMERICAN CHAMBER OF COMMERCE 1985).

In the Federal Republic of Germany, this shift in the burden of proof goes back to the famous 1968 *Huehnerpest* (poultry disease) decision¹⁴ by the German Federal Supreme Court, which has been followed by German courts ever since. The manufacturer is free of any liability when he succeeds in exonerating himself. This was, for instance, the case in the significant *Haspel* (winch) decision,¹⁵ where a winch broke and the mine cage plunged to the bottom of the mine shaft causing miners to lose their lives. The manufacturer of the winch was able to escape liability by proving that the break was attributable to the inferior quality of the steel used in his winch, that he had not been able to recognize this fact and that he did not have reason to suspect that the otherwise dependable steel producer would supply a bad product.

As a rare exception to the rule that a defendant in a tort action is only liable for fault, there are some special laws providing for strict liability in tort. In the Federal Republic of Germany, the most important are: section 84 of the Pharmaceutical Products Act,¹⁶ under which the manufacturer of pharmaceutical products is liable even without fault for damages caused by his products (the manufacturer's liability is limited to 200 million German marks per product and 500,000 marks for each incident); the Atomic Energy Act,¹⁷ providing for liability resulting from thermonuclear fission and radiation; section 22 of the Water Resources Management Act,¹⁸ providing for liability for damage caused by the emission of substances into waters; and section 7 of the Road Traffic Act,¹⁹ providing that the owner of a motor vehicle is liable for damages resulting from the operation of his vehicle except when the accident is unavoidable.

Similarly in France, Belgium and Luxemburg, the owner (*gardien*) of an object is responsible for damages resulting from the use of that object,²⁰ except in the case of an act of God (force majeure). In Spain, a new Consumer Protection Act enacted in 1984 also provides for non-fault liability with regard to those products where strict regulations exist, such as food, pharmaceuticals, cosmetics, electrical appliances, vehicles, etc.²¹

14. German Federal Supreme Court Gazette 51, p. 911.

15. German Federal Supreme Court decision of February 16, 1972, in *Versicherungsrecht* p. 559 (1972).

16. Pharmaceutical Products Act of August 24, 1976, Federal Gazette 1976 I, p. 2445 as amended on February 24, 1983, Federal Gazette 1983 II, p. 169.

17. Atomic Energy Act of October 31, 1976, Federal Gazette 1976 I, p. 3053, as amended on July 15, 1985, Federal Gazette 1985 II, p. 1565.

18. Water Resources Management Act of October 16, 1976, Federal Gazette 1976 II, p. 3017.

19. Road Traffic Act of December 19, 1952, Federal Gazette 1952 I, p. 837.

20. See Hollmann, *supra* note 12, at 2390.

21. Ley 19 Julio 1984, num 26 84 Consumo General para la defensa de los consumidores y usuarios, Aranzadi, Repertorio Cronológico de Legislación, 1984 volumen II, primera edición.

Since this act must be implemented by regulations, no concrete experiences are available so far.

II. Parties against Whom Claims May Be Asserted

The second most significant feature of the new Council Directive is the expansion of the scope of the parties against whom claims may be asserted.²² Art. 3(1) of the Directive sets forth that the manufacturer of a finished product, as well as the supplier of any raw material or component part, is to be deemed a "producer." This is in conformity with most European laws. Under German law, for instance, the producer of the finished product and the producers of defective raw materials and component parts are jointly and severally liable.²³ However, the producer of the finished product can exonerate himself by showing that he had reasonably investigated the suppliers and found them to be reliable and trustworthy. The manufacturer is not required to conduct a costly physical and technical inspection of the supplied parts.

In contrast to most European laws, the Council Directive additionally provides for liability of "quasi-producers," i.e., parties who by putting their names, trade marks or other distinguishing features on the product hold themselves out to be producers. While this inclusion of "quasi-producers" is not altogether alien to the United States concept, German courts have so far predominantly held that a party who, albeit under his own trade name, only markets a product manufactured by someone else, is not deemed a manufacturer for purposes of product liability;²⁴ he is thus not subject to the principles of product liability unless he had knowledge of previous accidents or of circumstances suggesting that close inspection was required.

Parties who import commodities into the Community for sale, hire, lease or any form of distribution in the course of business may also be made parties to a product liability suit even though not holding themselves out as producers.²⁵ The reasoning behind this is that there should be at least one party within the Community who may be held liable. Where the producer of the product cannot be identified, a product liability claim may also be asserted against each supplier of the defective product unless he reveals the producer or his own supplier.²⁶ The rationale being to protect consumers against "anonymous" products. By contrast, the various wholesale and retail sales levels are not subject to product liability under

22. Council Directive, *supra* note 1, at art. 3(1).

23. Schwarz, Sabagh, Peltzer & Schuecking, *supra* note 13, at 52.

24. German Federal Supreme Court, in: *Neue Juristische Wochenschrift* 1980, p. 1219.

25. Council Directive, *supra* note 1, at art. 3(2).

26. *Id.* at art. 3(3).

German law,²⁷ except for possible claims of buyers under the theory of breach of express or implied warranties. These contractual claims, however, can only be asserted where privity of contract exists and thus usually do not apply between the injured consumer and the producer.

The Council Directive provides that multiple defendants share joint and several liability.²⁸ The Directive does not address the issues of contributory negligence or recourse between the defendants. Since these issues are decided by the provisions of national laws, which differ, some divergence of outcomes in similar cases is to be expected.

III. Product Defects

The definition of product defects is based on customer expectations. The product is defective²⁹ when it does not provide the safety which a person is entitled to expect, taking into account the presentation of the product,³⁰ its reasonably expected use,³¹ and the time when the product is put into circulation.³² Criticism has been voiced that this definition creates a subjective rather than an objective standard and also that there is ambiguity concerning whether the definition refers to the expectations of a particular person who had suffered injury or to the expectations of a typical and reasonable consumer.³³ Although the wording of the Directive might be construed in the former way, I believe that it is clear that the standard of the public in general, i.e., a reasonable consumer, is decisive.

There is also doubt as to what point in time is decisive concerning the consumer expectations. Is it the time when the product was put into circulation or the time of the court decision? This question raises the problem of whether a product is deemed to be defective even where the defect was unforeseeable based on the state of scientific and technical knowledge at the time when it was put into circulation. Considering the sweeping scope of the wording of art. 6(1) and taking into account that art. 7(e) expressly provides a "state of the art" defense for producers, I

27. Schwarz, Sabagh, Peltzer & Schuecking, *supra* note 13, at 53.

28. Council Directive, *supra* note 1, at art. 5.

29. *Id.* at art. 6. Concerning the definition of product defects, see Blenk, *Zum Fehlerbegriff im Richtlinienentwurf: Produkt Haftung*, in 1978 DER BETRIEB 1725; von Huelsen, *Ist die von der EG-Kommission vorgeschlagene Form der Produzentenhaftung eine gute Lösung?*, in 1977 RECHT DER INTERNATIONALEN WIRTSCHAFT 373; Löffelmann, *Der geänderte Richtlinienentwurf der EG-Kommission zur Produkt Haftung*, in 1980 RECHT DER INTERNATIONALEN WIRTSCHAFT 161.

30. Council Directive, *supra* note 1, at art. 6(1)(a).

31. *Id.* at art. 6(1)(b).

32. *Id.* at art. 6(1)(c).

33. Hollmann, *supra* note 12, at 2392.

2025865437

believe that courts will interpret the consumer expectations *ex post facto* at the time of the court decision, and interpret "defects" in the broad sense used by United States courts under the theory of strict liability.³⁴

As far as the use of the product is concerned, the Directive's wording provides that "the use to which it could reasonably be expected that the product would be put" is decisive.³⁵ This wording constitutes a change from the revised Commission Recommendation which provided that a product was defective when, "being used for the purpose for which it is apparently intended," it fails to meet the consumer's reasonable expectations.³⁶ Under the Council Directive, the producer cannot rely on the consumer's using his products only for a proper purpose, but must take a certain degree of misuse into account unless this misuse deviates too much from reasonably foreseeable consumer behavior. The bounds of reasonable behavior are not strictly defined. This means in effect that producers have to take precautions against possible misuse and also give adequate warnings that particular forms of misuse could result in injury to the consumer.

IV. Defenses to the Claim

While the Directive leaves the issues of contributory negligence and assumption of risk to the national laws of the member states,³⁷ it expressly provides in art. 7 for special defenses on which the producer must bear the burden of proof. The first such defense refers to the situation where the producer did not put the product into circulation.³⁸ A second form of defense is proof that the defect which caused the damage probably did not exist at the time when the product was put into circulation or that the defect came into being later.³⁹ The key word here is "probably." Under the laws in most European countries, the injured party must show that the defect existed at the time the product was put into circulation.⁴⁰ Although the courts have partially relaxed this burden of proof, the Council Directive works to the producer's disadvantage⁴¹ because this proof might be difficult, especially where the defect is discovered many years after production. Although the producer must show only a probability,

34. See von Huelsen, *Produkthaftungspflicht USA, 1978-79—Ehren fuer Europa*, in *RECHT DER INTERNATIONALEN WIRTSCHAFT* 1979, p. 365.

35. *Council Directive*, *supra* note 1, at art. 6(b).

36. *Commission Recommendation*, *supra* note 7, at art. 4.

37. *Council Directive*, *supra* note 1, at art. 5 & 8.

38. *Id.* at art. 7(a).

39. *Id.* at art. 7(b).

40. Schwarz, Sabagh, Peltzer & Schuecking, *supra* note 13, at 66ff.

41. Von Huelsen, *supra* note 29, at 376.

he still does bear the ultimate burden of proof; thus, where no real evidence is available, courts must decide in favor of the consumer.

The producer is not liable when the product was not manufactured for sale or any other form of distribution for commercial purposes nor manufactured or distributed by him in the course of his business.⁴² This defense creates an exemption for articles made for private use or consumption and products of hobbies.

Another possible defense is that the defect was due to the product's compliance with mandatory regulations issued by public authorities.⁴³ This wording could be misunderstood. It does not mean that the producer is free of liability when he observed the official safety standards—this would not suffice to exonerate the producer. Likewise, the producer would not be automatically exonerated if he complied with the norms and standards in the industry. What it means is that the producer is free of liability if the legal requirements were the *cause* of the defect. Certainly, this requirement will rarely be met, and the defense will probably not be raised very often.

A more important defense which is open to producers is the "state of the art" defense which provides that the producer shall not be liable when he proves that considering the state of scientific and technical knowledge at the time the product was put into circulation there was no way of knowing that the defect existed.⁴⁴ This "state of the art" defense, which had not been included in the Commission Recommendation,⁴⁵ was brought in as a concession, and otherwise the Directive would probably not have passed. The concern shared by some member states and European industry was that technical and scientific development would be adversely affected because costs for compensation of damages and insurance premiums would be prohibitive. Introduction of new products would be subject to excessively high risks.

The "state of the art" defense does not limit the producer's duty of care to observe and monitor his products subsequent to introduction and thus to minimize risks to the consumers. This duty is acknowledged in most European countries. For example, the German Federal Supreme Court held in the famous *Estil* case⁴⁶ that the producer was to be charged with negligence in product supervision, where prior to the plaintiff's accident the producer had a duty to recall the product from the market or

42. *Council Directive*, *supra* note 1, at art. 7(e).

43. *Id.* at art. 7(d).

44. *Id.* at art. 7(e).

45. *Cf. Commission Recommendation*, *supra* note 7, at art. 5.

46. German Federal Supreme Court *Gazette* 59, p. 172 (in that case, the physician injecting the anesthetic at the elbow joint inadvertently mistook an artery for a vein).

to at least give more specific instructions and warnings concerning the dangers involved in its application. Other cases are on the same line.

According to art. 15(1)(b) of the Directive, the member states are free to provide in legislation that the exonerating "state of the art" defense will not be admitted. This option was designed to give the member states the opportunity to retain laws and regulations which provide for strict liability, such as the German Pharmaceutical Products Act.⁴⁷ Whether the member states will by way of derogation provide for additional legislation is hard to predict. It is my view that this is not very likely and that it is not advisable to expand the scope of liability.

Last but not least, the Council Directive provides a special defense to the supplier of a component.⁴⁸ The manufacturer of a component part is free of liability if he can show that the defect is not attributable to the inferior quality of his product, but rather to the design of the finished product in which the component part has been installed or to the instructions given by the producer of the finished product. Although this wording only mentions the supplier of components, it seems obvious that the defense would also be available to suppliers of raw materials. One might argue that this defense is not necessary because in this situation the supplied product is simply not defective. However, the express availability of the defense makes it clear that the injured party bears only the burden of proof that the *finished* product is defective, leaving the supplier of the component to prove that the defect was attributable to the other causes cited.

V. Extent of Recoverable Damages

Article 9 of the Council Directive provides for compensation of damages caused by death or personal injury. Whether damages to property should also be recoverable was controversial. The Council Directive now provides that if the defective product caused damage or destruction to other commercial objects, damages are not recoverable.⁴⁹ However, damages for items ordinarily intended for private use or consumption are recoverable,⁵⁰ subject to a threshold deduction of 500 European Currency Units (ECU)—about \$ 480. This threshold should serve to deter excessive litigation in minor cases.

As far as damages for death or personal injury are concerned, the Council Directive—in deviation from the Commission Recommendation

⁴⁷ See *supra* note 16.

⁴⁸ Council Directive, *supra* note 1, at art. 7(f).

⁴⁹ *Id.* at art. 9(b).

⁵⁰ *Id.* at art. 9(b).

which set a ceiling of twenty-five million ECU⁵¹—does not set a financial limit on the producer's liability. This point has been very controversial, and the German delegation had pleaded for a limitation on liability. Still, the Directive does recognize that a system of non-fault liability without an upper limit might contravene legal traditions in most member states and therefore be inappropriate. Art. 16 therefore leaves an option to the member states to deviate from the principle of unlimited liability by providing for a limit on the producer's total liability for damages resulting from death or personal injury. This limit may not be less than seventy million ECU,⁵² equaling approximately \$ 65 million. Considering the position the German delegation had taken during the negotiations, it is my belief that the German legislation will exercise the option and provide for a financial ceiling on producers' liability.

The Council Directive—unlike the United States legal system of product liability—does not provide for punitive damages or for compensation for pain and suffering and other non-material damages. With regard to those damages, the national provisions shall apply.⁵³ In the Federal Republic of Germany, liability is generally limited to compensatory damages.⁵⁴ However, in case of injury to the body or health, or in the case of deprivation of liberty, even non-pecuniary damages, i.e., damages for pain and suffering, are recoverable under section 847 of the German Civil Code.⁵⁵ Where the injury results in the death of a person, under German law the dependents have no right of their own for pain and suffering. Compared to the awards rendered by United States courts, the maximum awards and also the average awards rendered by German and other European courts are much lower.

VI. Conclusion

The Council Directive's goal is to provide for improved consumer protection by introducing the principle of non-fault liability on the part of producers, which with a few statutory exceptions has hitherto been alien to the European legal systems. The Directive also expands the scope of parties against whom a product liability claim may be asserted, thus changing the legal concept of "producers' liability" to a concept of "product

⁵¹ *Commission Recommendation*, *supra* note 7, art. 7.

⁵² *Council Directive*, *supra* note 1, at art. 16(1).

⁵³ *Id.* at art. 9.

⁵⁴ Schwarz, Subaghi, Peltzer & Schuecking, *supra* note 13, at 62.

⁵⁵ Section 847(1) of the German Civil Code reads: "In the case of injury to the body or health, or in the case of deprivation of liberty, the injured party may also demand fair compensation in money for non-pecuniary damages. This claim is not transferable, and does not pass to the heirs, unless it has been acknowledged by contract or an action on it has been commenced."

OVERVIEW OF THE KRAFT CRISIS MANAGEMENT PROGRAM

The following is a general outline of the Kraft Crisis Management Program. Key components of the Program include:

- A Crisis Task Force;
- An Alerting System for Task Force members and other key personnel;
- A Crisis Communication Center;
- A Consumer Hotline;
- A Telecommunications Network; *and*
- "White Papers" on various types of product contamination.

The Crisis Task Force

The Crisis Task Force is comprised of:

- A Crisis Coordinator from the Law Department (Don Carlin);
- A representative of the Corporate Communications Department (Mardie MacKimm);
- A representative of the Quality Assurance Department (Ron Case);
- A representative of the Consumer Affairs Department (Eloise McKitric);
- A Kraft security officer (John Hogan);
- A representative of the Systems Department (Don Abel); *and*
- A food and drug law attorney (Ed Thompson).

The current members of the Kraft Task Force, who have worked together on the Task Force for several years, have dealt with at least one hundred mini-crises and several major ones. This is an important advantage in dealing with situations in an efficient manner without overreacting yet protecting the corporation's image and minimizing liability.

There is at least one back-up individual for each member of the Task Force. In addition, there are a number of individuals identified who may become involved in some, but not, all situations. For example, the Senior Vice President of Human Resources has been identified as an ancillary member of the Task Force. He would

2025865442

only be called upon, however, if a large number of employees were directly affected by the situation (e.g., a plant explosion) or if a communication or message to all employees were deemed appropriate. As with the regular members of the Task Force, all ancillary members have a designated back-up.

Alerting System

There is a time-tested alerting system for the members and ancillary members of the Task Force. Each member of the Task Force has a pager, and a wallet card is provided to each member of management, as well as each member of the Task Force, which lists the office, home, and pager telephone numbers of each member of the Task Force, and the office and home telephone numbers of each member of senior management. In addition, Task Force members, as well as the Security Guard Station at Glenview Headquarters, have a binder which contains the office and home telephone numbers of all of the ancillary members and their back-ups, plus several other telephone numbers at which members of the Task Force might be reached in an emergency.

When a situation arises which is, or could develop into, a crisis, the Crisis Coordinator is to be called immediately. If he is not available, another member of the Task Force will be called. If, in the judgment of the Crisis Coordinator, the matter is not serious at the time of the call, he will ask to be kept informed and might not notify any other members of the Task Force. If he believes the situation could develop into a crisis, he notifies the other members and asks them to remain available and be certain he has a number at which they can be reached. If there is an actual crisis, assignments and directions are given to the Task Force members immediately. It is the responsibility of the Crisis Coordinator to keep senior management advised of any situation that could be, or is, a crisis.

Perhaps the single most important lesson the Kraft Task Force learned as it developed the Crisis Management Program is the need to channel all communications through the Crisis Coordinator. During a crisis, it is imperative that decisions be based upon the most recent and accurate set of facts. Further, key members of the Task Force cannot work efficiently if they must repeat the same narrative four or five times to other members of the Task Force.

2025865443

Crisis Communications Center

The fifth floor of the West building of the Glenview Headquarters complex can be converted into a Crisis Communications Center in approximately two hours during a normal work day or in approximately four hours if support personnel must be contacted at home and asked to come in. The Center includes a conference room converted to accommodate fifteen Consumer Hotline phones in sound proof carrels, an adjoining conference room to be used as a briefing room/training center for the Hotline operators, a media room wired to accommodate seven phones for receiving media calls, a media conference/strategy room, a media monitoring room permitting three different television stations to be viewed and taped simultaneously, an additional "executive" conference room, private offices set aside for each member of the Task Force plus an additional private office for a medical adviser, and the Business Research Library converted to accommodate an additional twenty Consumer Hotline phones with carrels.

Consumer Hotline

The Consumer Services Department has a list of the names, addresses, and office and home phone numbers of two hundred employees in the Glenview complex who have been trained to receive consumer calls during a crisis and to complete a specially designed form for each call. Approximately 45 persons would form a "shift" during a crisis, with 35 on the phones and the others providing relief, assistance, and supervision. The Consumer Hotline, with 35 telephones in service, is activated only when it is necessary to communicate directly with consumers, either to reassure them, to make certain they are aware of relevant product codes, or to receive information from them. The Hotline is activated, as a practical matter, when an 800 number which has been reserved solely for this purpose, is published in a press release, or is otherwise communicated to the media.

When it appears that the Consumer Hotline may be activated, the Consumer Affairs Department and the Corporate Communications Department prepare questions and answers based upon the information then available, and these questions and answers are updated regularly during a crisis. Each telephone operator has a set of questions and answers to use while he or she speaks to a consumer. However,

2025865444

if a question is asked to which the operator does not have an answer, the operator will try to obtain the answer while the consumer is on the line (through a supervisor) or will call the consumer back. All telephone personnel are briefed for 30 minutes before they go on duty and are debriefed before they go off duty.

Telecommunications Network

The Telecommunications Network includes a system for handling three levels of consumer call volume. During normal working hours, the Consumer Hotline at the Old Orchard building is capable of handling six consumer calls simultaneously, although calls may be held if all lines are busy. If a mini-crisis develops, this capability can be immediately increased to 14. If there is a more serious crisis, the capability can be increased to 35 with all calls being routed to the Crisis Communication Center. The Old Orchard facility will remain operative to handle noncrisis-related consumer calls.

The system also makes it possible to provide a short recorded message (*e.g.*, one containing the content of the press release and a list of suspect product codes) plus a statement which invites the caller to stay on the line at the conclusion of the message if he or she has a specific question. This permits communication with many more consumers. It may also be possible to obtain from AT&T a 900 number which can provide 12,000 recorded messages simultaneously and which can furnish consumers with an 800 number to call if they have further questions.

The Telecommunications Network also permits instantaneous switching of consumer calls to the Crisis Communication Center from other locations, such as the Dairy Group's Headquarters in Philadelphia. It provides for the installation of phones in the Crisis Communication Center, the provision of separate numbers for the assigned private offices in the Center, and includes a telephone switching device which makes it possible to arrange a conference call with up to 25 participants if desired. Speaker phones can also be set up in the board room, the executive dining rooms, and all conference rooms.

White Papers

At the time of the Listeria recall a few years ago, it became apparent that there was not sufficient knowledge readily available within Kraft about that

2025865445

microorganism and Listeriosis to answer questions or make accurate statements to the media. Accordingly, an expert was commissioned to prepare a scientific paper on a number of topics. Corporate Communications then rewrote the paper so that it provided the information in a form in which it could be easily communicated and prepared questions and answers as well. The papers provided such information as the prevalence of the microorganism in the environment, the normal symptoms of someone who becomes ill, any other unusual symptoms, what type of person is most at risk, the incubation period, and how the microorganism enters the food supply, and so on.

Other Considerations

The Kraft Crisis Management Program is not limited to product defects. It can also respond to actual tampering, threats of tampering, product extortion, kidnapping, and major catastrophes such as plant explosions, and earthquakes. Nor is it limited to Glenview. There will eventually be a mini-plan in place at all of the company's facilities.

2025865446

**GENERAL FOODS CORPORATION
NATIONAL SALES POLICY**

G O V E R N S	GF USA	
	Effective: 7/1/88	
	Sec. I	10.A.

TITLE: DEFECTIVE PRODUCTS AND RECALLS

SUBJECTS COVERED:

- Recall Policy
- Recall Class/Type of Hazard
- Decision to Withdraw or Recall
- Recall Effectiveness Reporting
- Field Sales Identified Hazard
- Product Liability
- Sales Function Action Group
 - Crisis Committee
 - Vice President - Sales
 - Sales Recall Coordinator
 - Central Sales Administration Crisis Communication Center
 - Retail Coordinator
 - Field Sales
- Appendix
 - Product Contingency Action Plan
 - Recall Plan
 - Sales Function Action Group
 - Geico Rapidraft Instructions
 - Product Recall Effectiveness Log

POSITIONING STATEMENT:

It is the policy of General Foods USA to withdraw or recall products from customers or consumers when product quality criteria fail to meet critical specifications or present a danger to health. The purpose of this policy and procedure is to clearly outline the roles and responsibilities related to the recall of defective products and the subsequent pick-up from our customers by General Foods USA Field Sales Personnel.

POLICY:

General Foods USA must respond to product safety problems when they occur with a sense of urgency to protect our consumers and franchises. All Divisions will conduct a continuous review of pertinent defect information dealing with product quality faults and respond by appropriate prudent action to the severity of the problem. The Crisis Committee is established to have a group of experts that can be convened expeditiously to prevent or manage highly volatile product situations requiring immediate remedial action.

Effective: 7/1/88

Sec. I

10.A.

POLICY (continued)

The Crisis Committee under the leadership of the Senior Vice President of Quality Science and Technology will serve as a resource to the appropriate General Manager and ultimately to the Chief Executive Officer General Foods USA who will make the final decision on all crisis issues.

The Field Sales Action Group as well as other technical and sales resources will give full support to the Crisis Committee. The health hazard evaluation must be a technical and medical safety-oriented procedure. The Crisis Committee will coordinate all activities, recommendations and presentation to the Company President and the Chief Executive Officer for a final decision on actions to be taken.

Serious health or safety threats will be treated as emergencies and products will be embargoed from sale or recalled from appropriate levels of distribution or from consumers, if appropriate.

Recall Class/ Hazard Type

A product withdrawal, for purposes of definition in this policy, is a product removal involving no violations or only minor violations that would not normally be subject to legal action. A product recall involves a product defect which has safety or health implications and may be further classified* as follows:

<u>Recall Class</u>	<u>Hazard</u>
I	A situation in which there is a reasonable probability that the use of, or exposure to, a violative product will cause serious adverse health consequences or death.
II	A situation in which the use of, or exposure to, a violative product may cause temporary or medically reversible adverse health consequences or where the probability of serious adverse health consequences is remote.
III	A situation in which the use of, or exposure to, a violative product is not likely to cause adverse health consequences.

* Classification corresponds to FDA Recall Procedures, 2/18/76.

POLICY (continued)**Decision to Withdraw or Recall**

When the decision is made to withdraw or recall a product, the procedures to locate and remove products will be put into action as soon as possible. When in doubt, the intent is to act conservatively and responsibly in order to protect consumers and the long-term objectives of General Foods USA. Risk-taking for cost avoidance purposes on a short-term basis must be subordinated to consumer safety and to the potential long term impact on the franchise. Each defect circumstance will be considered unique and require its own recall strategy. It is the responsibility of the Crisis Committee to determine those steps required in each case.

General Foods is required to notify the FDA if and when we initiate a recall. All recall notices will be reviewed with the FDA prior to issuance by the Law Department.

Recall Effectiveness Reporting

In the event of a recall, General Foods will be required to take certain actions to ensure that the recall was effective and to file reports with the Food and Drug Administration showing actions were actually taken. In order to file these reports, it is essential that accurate records be maintained with respect to each action.

Sales has the primary responsibility to notify our customers of any product recalls. Copies of the recall notice, conspicuously marked **URGENT**, should be sent to all direct customers by telefax, telegram, mailgram or first class mail (in envelopes prominently marked **URGENT**). Follow-up contacts and contacts with retail customers should then be made by either telephone or personal visit. Whatever the means of communication, it is important that we conduct the recall in a way that is designed to cause the customer to remember the contact. In addition when GF representatives visit stores to pick up product, they should announce themselves to the store manager and leave a copy of the recall notice, whether or not they actually find the recalled product in the store.

Each person involved with the recall must maintain a log of customer contacts and actions taken. This is required for review by the Food and Drug Administration. A copy of all logs will be forwarded to the Retail Coordinator for review and reporting to management on the actions taken during the recall.

There is a presumption on the part of the FDA that customers will return products to the manufacturer in response to the recall notice. Therefore, the FDA requires the manufacturer to conduct recall effectiveness checks in accordance with a procedure, suggested by the FDA, to ensure that retail stores, in fact, receive copies of the recall notice. The log of our activities is required to comply with the FDA requirements.

Effective: 7/1/88

Sec. I	10.A.
--------	-------

POLICY (continued)

Recall Effectiveness Reporting (continued)

The FDA may require General Foods to conduct recall effectiveness checks at a larger percentage of retail stores than is represented by our sales trip lists. This is because wholesale customers often ship our products to retailers which are not normally visited by GF sales representatives. While these wholesale customers are expected to send copies of the recall notice to their customers, FDA requires manufacturers to conduct effectiveness checks to make sure that this happens. When this situation arises, visits and calls to trip list customers should be supplemented by telephone calls to other retailers until we have contacted at least the minimum percentage of retail stores required by the FDA.

After we have completed the recall, the FDA will send out inspectors to ask retailers if they were informed of the recall.

PROCEDURE:

FIELD SALES IDENTIFIED HAZARD

In the event a potential health hazard situation is identified by the Field Sales Organization the following actions are to be taken:

- The individual in the Field Sales Organization who identifies the potential hazard is to record all information related to the hazard and immediately contact their District Manager. The following information must be provided:

Source of information (customer, consumer, media, etc.),
brand, size, flavor, code date, type of problem and
location.

- The District Manager will immediately contact their Regional Manager, with full details of the potential hazard.
- The Regional Manager will immediately contact their National Sales Director who will advise the Vice President of Sales or his alternate (see Sales Function Action Group in appendix 3).
- The Vice President of Sales or the alternate will convene the Crisis Committee.
- In the event that the next higher level indicated above is not able to be reached the individual is to contact the Sales Recall Coordinator or alternate in White Plains (See appendix 3).

2025865450

Effective: 7/1/88

Sec. I	10.A.
--------	-------

PROCEDURE: (continued)

PRODUCT LIABILITY

General Foods product liability insurance provides that all General Foods customers are automatically carried as additional insured parties with respect to any product liability claim involving a product manufactured or distributed by General Foods. A defense will be provided, and indemnification, if necessary. It is not necessary for customers to obtain a certificate of insurance in order to obtain coverage under General Foods product policies.

SALES FUNCTION ACTION GROUP

The Crisis Committee through the Vice President of Sales or the alternate will notify the Sales Recall Coordinator of specific actions to be taken.

The Sales Recall Coordinator will activate the Central Sales Administration (CSA) Crisis Communication Center.

The CSA Crisis Communication Center will:

1. Act as the official Sales Communication Center for all product issues or recalls:
 - Receive all instructions from the Crisis Committee through the Sales Recall Coordinator.
 - Maintain a complete listing of all Sales Forces to include location, mailing address, telephone and FAX numbers.
2. Disseminate all official communications from the Crisis Committee:
 - Notify all involved Field Sales Organizations.
 - Notify all direct customers through the Field Sales Organization.
 - Refer all questions or issues from customers or Field Sales to the Crisis Committee through the Sales Recall Coordinator.

Effective: 7/1/88

Sec. I	10.A.
--------	-------

PROCEDURE: (continued)

SALES FUNCTION ACTION GROUPS (continued)

3. Communicate and coordinate all product recalls:

- Prepare and review all documents and communications to be transmitted to Field Sales and customers for clarity, accuracy and completeness.
- Prepare customer recall letter for the Vice President of Sales signature.
- Insure that all appropriate locations receive complete documentation on recall by the fastest most appropriate method (FAX, Overnight Mail, TWX, computer).

4. Establish payment procedure and accounting controls for the pick-up of product:

- Special deal numbers will be established for each recall.
- Payments may be made through the Galco Pay-by-Draft system or cash (see appendix 4) from existing trust fund and documented on expense reports.

5. Direct D-SSD activities to support recall:

- Contact D-SSD Management (General Manager or Operations Manager) early in the process. D-SSD field personnel are likely to receive inquiries from the media and should be fully informed on the situation and their proper response.
- Conduct code date audits at all Field locations to determine the presence of the affected product; freeze existing inventories and impending customer shipments.
- Determine the customer locations which were likely recipients of the affected product (records are maintained by month and year, not by lot or specific code date).
- Should any affected product be intransit to customer warehouses, notify the carrier(s) to return the product to a location designated by D-SSD.
- Arrange for storage and quarantine of returned product.

2025865452

Sec. I	10.A.
--------	-------

PROCEDURE: (continued)

SALES FUNCTION ACTION GROUPS (continued)

6. Record all communications and actions:

- Document all incoming and outgoing communications and actions taken.
- Develop a summary report of all communications and actions taken for the Crisis Committee.

7. Solicit support of other companies resources, if needed, to effect product pick-up.

8. Provide additional support to the Crisis Committee as required or requested.

The Retail Coordinator will be the liaison between the Crisis Committee and the field sales organization. The Retail Coordinator will be responsible for directing the activities of the field sales organization during the recall and reporting their activities and effectiveness to management, in compliance with FDA requirements.

Field Sales will be responsible for notifying all direct customers of a product recall. Additionally, field sales will be required to:

Pick up product off retail shelves.

Pick up product from consignment warehouses.

Communicate product return instructions to customers and authorize return to central location.

Record all activities in a Product Recall Effectiveness Log (See appendix 5).

Forward a copy of all logs to the Retail Coordinator when the recall is completed.

APPENDIX

1. Product Contingency Action Plan
2. Recall Plan
3. Sales Function Action Group
4. Gelco Rapidraft Instructions
5. Product Recall Effectiveness Log

2025865454

**VII. Materials for Legal
Department Sessions**

LEGAL DEPARTMENT SESSIONS

PURPOSE On Wednesday morning, after the conclusion of the product liability and product recall panel, the conference will change its focus from key business and legal issues to a series of sessions specifically concerning the organization and operations of the legal department. The purpose of these sessions is to provide lawyers from different operating companies an opportunity to exchange their views on departmental operations and in so doing identify strategies to ensure that the department maintains a standard of excellence.

GENERAL COUNSEL PRESENTATIONS The first segment of the legal department sessions consists of general counsel presentations describing the parent and operating company legal departments individually. These presentations will supplement the legal department overview in Tab III of this notebook by providing additional information about the various departments and their approaches to in-house practice.

BREAKOUT SESSIONS After the general counsel presentations, the group will divide into nine discussion groups, each of which will have a cross-section of the company's lawyers. The breakout groups will meet simultaneously for two hours of discussion.

Discussion Leaders/Reporters Each breakout group has a discussion leader who will ensure that the group gives full attention to the topics under discussion. In addition, the discussion leaders will report back to the plenary session on the last morning of the conference. Each report should summarize the group's discussion and present any recommendations which the group may have. The reports should last approximately 10 minutes a piece. The discussion leaders/reporters should feel free to meet after the breakout sessions and compare their groups' respective views

2025865455

of the issues under consideration. After the reports have been given, the reporters will sit as a panel to answer questions from the audience. The discussion leaders/reporters are identified in the list of breakout group assignments.

Topics. The breakout sessions will address a total of five broad topics related to legal department operations -- *department structure, sharing legal resources, computerization, recruiting, and outside counsel*. All groups should discuss department structure and sharing legal resources. In addition, one of the other three topics has been assigned to each group for discussion. Time permitting, the groups should feel free to discuss the remaining topics as well.

Composition of Groups The groups are made up of lawyers from different companies whose major practice areas are similar and of lawyers from the same foreign country. The groups are composed in this way *solely* to provide a common context in which to discuss procedural and organizational issues.

2025865456

SUGGESTED QUESTIONS FOR DISCUSSION

A. Department Organization and Operation (All Groups)

1. What are the advantages and disadvantages associated with organizing lawyers to reflect operating company structure (*i.e.* assignment to a particular business division) versus organization according to legal specialty?
2. What is the functional difference between *proactive* and *reactive* lawyering? How do those concepts currently come into play in each department's day to day practice? How should they?
3. What is the relationship between the individual legal departments and their clients? Would more or less client contact be useful?
4. Is work evenly distributed within the departments? (*See also Question B,4*)

B. Sharing Legal Resources (All Groups)

1. Is there a need for greater sharing of legal resources within the legal department?
2. What areas or issues (*e.g.* development of antitrust or other compliance programs) are best suited for coordination among the individual legal departments?
3. What are the best methods for sharing resources or for coordinating otherwise independent activities?

2025865457

4. Is it practical to distribute the legal work related to one operating company to another operating company's legal department? Under what circumstances?

C. **Computerization (Groups E, H, I)**

1. Would additional computer systems make the department more efficient?
2. What types of systems (*e.g.* electronic mail, matter tracking, brief banks, electronic document transfers, etc.) would be most useful?
3. Have your outside counsel developed or used computer systems on your behalf? Have those systems been satisfactory in terms of cost, utility, and ease of use?
4. What role has your company's Information Services Department played in developing and maintaining any systems which you use?

D. **Recruiting, Training, And Compensation (Groups C, D, G)**

1. What are the advantages and disadvantages associated with hiring lawyers immediately or soon after they finish law school?
2. Should there be an emphasis on hiring more senior attorneys?
3. Have there been any difficulties in attracting lawyers to work for the company? What can be done?
4. How is training handled? Are attorneys satisfied with the training they receive?

2025865458

5. Are pay structures compatible with those at private law firms? *Can* they be?

E. Outside Counsel (Groups A, B, F)

1. For what types of matters are outside counsel most useful?
2. For what types of matters should outside counsel not be used?
3. At what stage of a project should outside counsel be consulted?
4. What should the criteria and procedures be for selecting outside counsel?
5. How should the use of outside counsel by non-lawyers, if any, be controlled or monitored?
6. What are the best techniques for managing outside counsel once they have been retained?
7. What policies regarding conflicts of interest should be adopted on a company-wide basis?
8. Should the company make a greater effort to use minority counsel? What is the best way to do so?

2025865459

BREAKOUT GROUP ASSIGNMENTS

GROUP A (Plaza Ballroom I)

Bailey	<i>Kraft General Foods Group</i>	Canada
Brooks	<i>Philip Morris</i>	United States
Campbell	<i>Kraft General Foods Group</i>	Canada
Carrillo	<i>Kraft General Foods Group</i>	Mexico
Cash	<i>Kraft General Foods Group</i>	Great Britain
Cross	<i>Kraft General Foods Group</i>	Canada
Dulles	<i>Philip Morris</i>	Switzerland
<u>Fleischmann-Fellowes</u>	<i>Kraft General Foods Group</i>	United States
Frey	<i>Kraft General Foods Group</i>	France
Hargrave	<i>Philip Morris</i>	Australia
Heeringa	<i>Philip Morris</i>	Holland
Johnson, F.	<i>Kraft General Foods Group</i>	Canada
Martin-Cuccio	<i>Philip Morris</i>	Switzerland
Milliken	<i>Philip Morris</i>	Australia
Pijnenburg	<i>Philip Morris</i>	Holland
Pollak	<i>Philip Morris</i>	United States

GROUP B (Plaza Ballroom II)

Beecken	<i>Philip Morris</i>	Germany
Celentano	<i>Kraft General Foods Group</i>	Brazil
Clarke	<i>Philip Morris</i>	Australia
Côté	<i>Kraft General Foods Group</i>	Germany
de la Torre	<i>Kraft General Foods Group</i>	Mexico

Underscore designates discussion leader/reporter.

2025865460